THE PROBLEMS OF THE
FOREIGN EXCHANGES

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THE PROBLEMS OF THE FOREIGN EXCHANGES

BY

L. L. B. ANGAS

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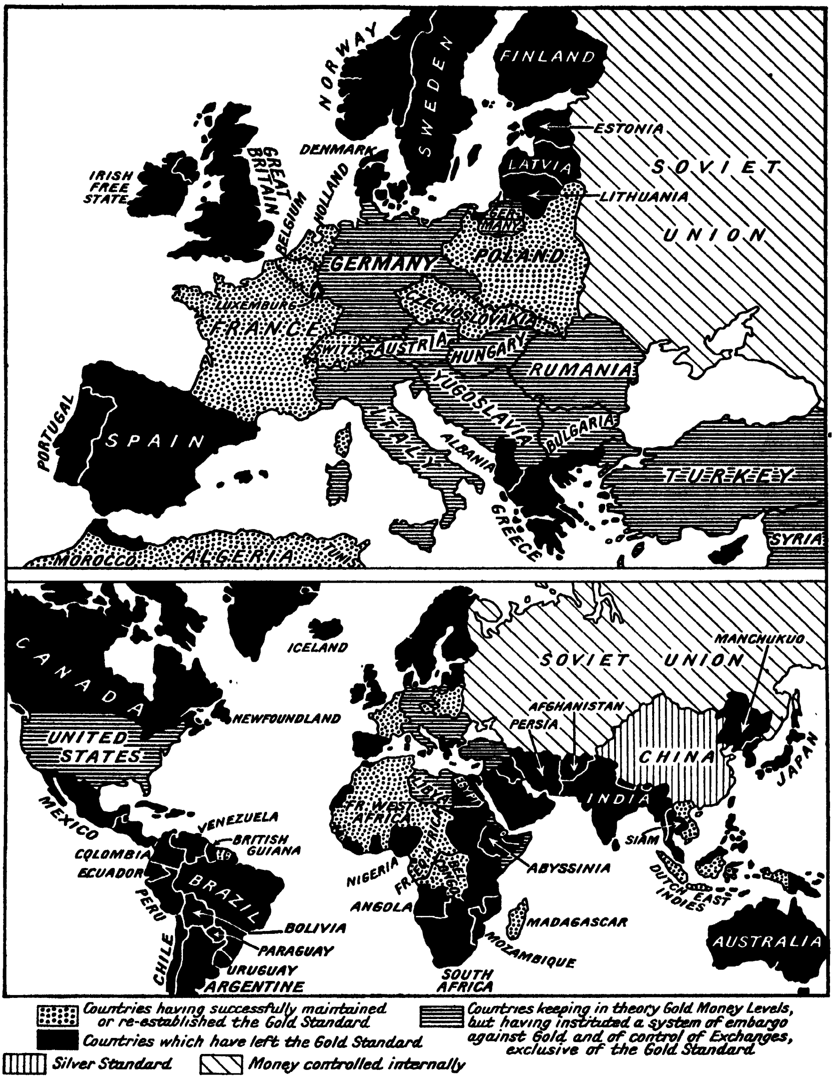
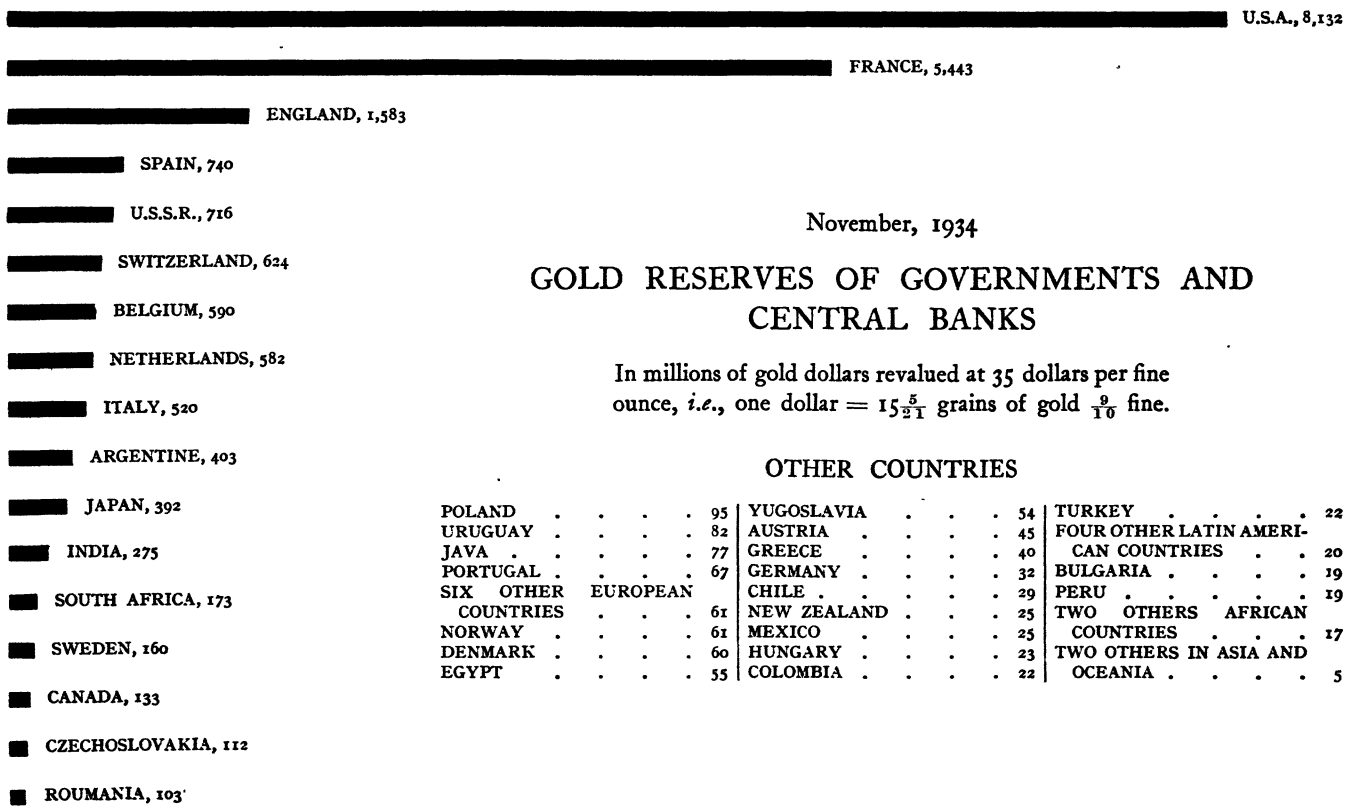
This map is reproduced by the kind permission of the Editor of The Listener. *Since its construction in 1934 Czechoslovakia has varied her parity. America, though now on a full gold standard, is, according to the Secretary of the Treasury, only on " a Twenty-four hour basis."*





November, 1934

GOLD RESERVES OF GOVERNMENTS AND CENTRAL BANKS

In millions of gold dollars revalued at 35 dollars per fine ounce, *i.e.*, one dollar = $15\frac{5}{21}$ grains of gold $\frac{9}{10}$ fine.

OTHER COUNTRIES

POLAND	95	YUGOSLAVIA	54	TURKEY	22
URUGUAY	82	AUSTRIA	45	FOUR OTHER LATIN AMERICAN COUNTRIES	20
JAVA	77	GREECE	40	BULGARIA	19
PORTUGAL	67	GERMANY	32	PERU	19
SIX OTHER EUROPEAN COUNTRIES	61	CHILE	29	TWO OTHERS AFRICAN COUNTRIES	17
NORWAY	61	NEW ZEALAND	25	TWO OTHERS IN ASIA AND OCEANIA	5
DENMARK	60	MEXICO	25		
EGYPT	55	HUNGARY	23		
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INTRODUCTION

THIS book, *The Problems of the Foreign Exchanges*, is the second of a Series. The two companion volumes are: I. *The Problems of Money*, and III. *Methods of preventing Unemployment and Bad Trade.*

In 1919 the Author retired from the regular army to study the problems of bad trade and unemployment. At that time, although several good books had been written on the subject, the problem of *general* trade fluctuation had not received the attention which its political importance deserved. The Author, therefore, decided to set himself the task of collecting further data on the subject, in the hope of being able to produce a "practical" treatise. His investigations naturally brought him into touch with numerous business men in the unemployed areas; but it soon became apparent that even if it were possible to produce an accurate analysis of the problem as a whole, it would meet with little attention from practical business men or politicians, for it was clearly the opinion of these groups that economic science was not yet sufficiently advanced to deserve serious attention from "practical" men. It therefore seemed necessary to anyone holding the belief that 'mere theory' was of more immediate value than was generally supposed, to make some attempt to demonstrate in practice the utility of applied economic principles. The most satisfactory method of making such a demonstration seemed to be to enter the investment field, where the proof of the pudding is in the eating—for in the investment market forecasting is necessary, and forecasts *must* be based on economic analysis.

In 1925 the Author published a preliminary pamphlet entitled *The Coming Collapse in Rubber.* This analysis was followed in 1930 by a purely theoretical treatise, entitled

Investment, on the art of forecasting profits and share movements. Subsequently further forecasts on the market were published, all of which, with one exception, have so far proved accurate.

Throughout these pamphlets the policy has been pursued of interspersing the various market forecasts with theoretical explanations of the causes of the movements in profits, trade, and employment. In all cases the public have shown a lively appreciation. Letters make it evident that, even among investors seeking personal profit, there is a widespread interest in the more fundamental social questions at issue.

As it happens, the problem which it was planned to study some sixteen years ago has now become the chief political problem of the day; the Author has consequently retired from active business in the City in order to hasten the production of these three volumes.

*　　　*　　　*

The general argument of this book is as follows:

The modern economic system suffers from six subtle monetary diseases; these diseases are undoubtedly the cause of unhealthy booms and depressions (see Chapter XII). To eliminate these diseases a deliberate form of monetary management is necessary. But to set in motion the necessary reforms is quite impossible under an *international* monetary system such as gold, for an *international* system requires that the internal supply of bank notes and credit shall be manipulated, not in order to help trade internally or to keep domestic prices stable, but in order positively to make prices *move*—so that the gold reserve shall be protected and the foreign exchanges kept at par. There is, in fact, an inherent conflict between the rigid gold standard and a stable internal measure of value. Unsound internal money, and trade fluctuation, are the necessary corollaries of fixed gold exchanges.

To the majority of people the desirability of fixed exchanges is so obvious that they immediately cry out for stabilisatio

But few ask themselves what internal monetary measures have to be taken to maintain stable exchange rates. Few realise the extent to which profits and employment are inevitably reduced by these necessary measures. It is also little realised to what extent the gold standard precludes the potential cures to bad trade and unemployment. In the opinion of an ever-increasing number of authorities, to get rid of the international gold standard must be the first objective of those who wish to cure recurrent unemployment and to prevent the anomaly of plenty causing want.

The Author has not hesitated to point out the various vested interests concerned, nor to show where the Power behind policy lies; and it is emphasised that although international bankers and traders think that the superficially attractive gold standard benefits them particularly, its secondary reactions often cause, in practice, a reduction in their aggregate business and a general diminution of their profits. Although *single* transactions in international trade and finance are made easier, the *total* volume is eventually reduced. International traders and financiers thus suffer at the hands of their imagined best friend.

The views expressed in this book will be regarded by many as unorthodox, but the failure of orthodoxy in practice to produce continuous prosperity justifies attention being paid to other constructive points of view. Even if the nations were willing to play the gold standard rules correctly, gold would probably not be the best form of currency; but since nations find it too painful to play the Spartan rules in practice, the case for new methods is further reinforced.

To range these matters in their proper perspective, from a nation-wide view-point, is the primary purport of this book.

L. L. B. A.

55 *Onslow Gardens,*
London, S.W.7.
March 1935.

PREFACE

To despise sound theory is entirely unpractical.

PART I

FIRST PRINCIPLES

If the Reader has not already read Volume I of this Series, he is recommended to read the four Appendices before commencing Chapter I.

CHAPTER I

CRUCIAL PROBLEMS

1. Only an international bank–credit–currency system can eliminate the problem of the Foreign Exchanges.
2. Such a system is not yet politically possible.
3. The popular plea for fixed exchanges.
4. A small-minded view of the foreign exchanges.
5. The necessity of taking a nation-wide view-point.
6. Methods of equating exports with imports.
7. The case against exchange and import control.
8. The primary function of the foreign exchanges is to cause fluctuations in " net external prices."
9. Alternative methods.
10. Is the expression " sound money " mere clap-trap ?
11. The statesman's dilemma.
12. Monetary ignorance.
13. The problem at issue.
14. Gold the best international system, but non-international paper is even better.

1. *Only an International Bank–Credit–Currency System can eliminate the problem of the Foreign Exchanges.*

It is generally agreed that the problem of the foreign exchanges is of vital importance to domestic and world prosperity. Yet, despite the obvious desirability of solving this problem once and for all, there are few subjects upon which there is so much prejudice and lack of perspective among business leaders, statesmen and bankers.

The problem of foreign exchange arises solely because different countries have different banking and note-currency systems (sometimes superimposed on a common metallic base). The currency medium of the present day no longer consists only of gold coins, but of bank deposits and notes based on gold, and these bank deposits and notes do *not* pass current in the different national areas.

In the absence of a universally acceptable note or credit currency, such as only a unified international banking system can provide, the inhabitants of separate countries must naturally

refuse permanently to accept payment in each other's notes or cheques.

If the internal bank money of every country circulated freely within the others, *i.e.* if there was only one universal bank, or if there was no bank money at all but only gold coin, the problem of the foreign exchanges would not arise. It is because the banking systems of the world are different that the problem of the foreign exchanges exists.*

But the fact that money has to be exchanged for money is not the only problem.

The non-international nature of bank-notes and deposits, coupled with the fact that the use of any form of money separates the exchange of goods for goods by a time factor, introduces the secondary problem of equating the international payment balance in goods. Somehow or other international payments, *via* paper and bank money, must give rise to equal payments in goods.

The problem presented by the lack of any universal money is this: all imports have to be paid for; exports and imports, therefore, must be made to balance. Debts, therefore, must ultimately be settled in either goods, services, securities or gold.

Notes and cheques are not legal tender abroad, and, even though they may be "based" on a common metal, gold, they are not themselves permanently acceptable by people abroad in payment of debts. A payment in paper money must, therefore, be accompanied by a corresponding payment in goods (or services). This, in fact, is what gives rise to the various problems of the foreign exchanges. Paper transactions must have corresponding transactions in goods.

2. *An International Bank Credit Currency System is not yet politically possible.*

As regards the gold standard, although it is usually referred to as being an international *monetary* system, it is not, strictly

* There is, I am aware, sometimes a rate of exchange between money in San Francisco and money in New York, but this is because the Americans have not yet instituted a *central* banking system.

speaking, an international *monetary* system at all, for it is merely an international *bank-reserve* system on which the various *non-international* bank-notes and deposit-currencies are based.

The ideal, of course, would be a true international monetary *and* banking system, but I need hardly say that a unified system is not yet politically possible. It would probably require the cancellation of all national notes and their replacement by international notes. It would also require the subjection of the central banks and member banks of all countries to the control of some world central bank. Individual governments would thereafter be unable to borrow from their own central banks without the sanction of the International Committee: single countries would, in fact, lose their monetary autonomy. The individual firms of each nation would also be subjected to the whims of a polyglot international banking board. Moreover, international trust, and monetary honour, would have to be sufficiently great to enable the peoples of the world to believe that, under no circumstances whatever, not even in war, would one country forge, or print, more than its statutory allowance of international notes.

Certainly if notes and bank deposit money were universally abolished, and if only coins were used internally and externally, this would eliminate our problem; but this again is politically impossible.

Since then an international banking system is not yet politically possible, and since countries must necessarily continue to use different forms of paper and bank-money, even though they may be based on a common metal, the mechanism of the foreign exchange market must remain in existence; and it must necessarily be such as eventually to equate, more or less *automatically*, both imports and exports, and demand and supply in the foreign exchange market. Somehow or other, by means of this mechanism, foreign debts and earnings, and receipts and payments, must all be made neatly to balance.

3. *The Popular Plea for Fixed Exchanges.*

This is the economic function of the foreign exchange market. And yet most discussions on the foreign exchanges centre *only* around the problem of how to keep exchange rates stable. People, in fact, rarely stop to ask themselves how exports are made to balance with imports under a fixed exchange system; or whether the attainment of exchange stability does not set up even greater instability in other departments of economic life, and thus do more harm than good.

It is, of course, a desirable feature of money that its value should be stable, not only internally, but *also* externally; for obviously it is most irritating to an English exporter, say, of motor-cars to Spain to conduct his business under fluctuating exchanges, since he will be unable to produce a Spanish catalogue quoting fixed peseta prices. If he risks it, future exchange fluctuations may wipe out all his anticipated profits, especially if he gives long credits and is trading for small profits on turnover. Similarly, the international banking community who trade for small differences in interest rates dislike exchange fluctuations. Overseas contractors, too, carrying out work abroad against successive instalment payments, desire stability of exchange rates. The same applies to long-term international lenders and debtors, and also to British assurance companies. Importers of raw materials also like stability so as to be able to plan programmes and estimate costs in relation to the prices they quote. Even domestic producers like stable exchanges lest unforeseen movements suddenly involve them in unexpected competition from abroad. There is, in fact, a vast body of interests that naturally cries out loudly for stable exchange rates.

On the other hand, there are very few persons who will positively cry out (as indeed they ought to if they want stable money) for "unstable exchanges" in the (sound) knowledge that by fluctuating exchanges *alone* they can be saved from those internal fluctuations in the value of money which upset the

value of all money debts and bring about internal bad trade, low profits, and unemployment. Few, in fact, realise that these disturbances *must* result from fixed metallic exchanges. Indeed, since these movements are subtle and widely diffused there is never any specific or vocal group either to agitate against them or positively to advocate the "fluctuating exchanges" which are the inevitable corollary of stable internal prices. The long-suffering public are, in fact, apt to support the more specific and more vocal foreign trading community, for whose benefit, as we shall show, they ultimately suffer.

4. *A Small-minded View of the Foreign Exchanges.*

No intelligent person, of course, will deny that exchange fluctuations, other things equal, make international trade and foreign investment more difficult and costly; nor will anyone in his senses deny that international trade and international investment are important factors in the economy of a nation, particularly a nation such as Great Britain. But, although it is desirable *per se* that the foreign exchanges should not fluctuate, it must never be forgotten (although it is habitually forgotten) that the foreign exchanges have a definite economic function to perform (in the absence of a controlled exchange or import market): and that function is to make exports balance with whatever imports a country fortuitously decides to buy from abroad. This, I assert without fear of contradiction, is the *primary* function of the foreign exchanges.

5. *The Necessity of Taking a Nation-wide View-point.*

Chance, it is true, may temporarily make exports and imports (visible and invisible) balance; but chance can never be relied on for long. Consequently if a country is not willing to ration the foreign exchange market, or deliberately to control its foreign trade and investment so as to keep imports and exports in equilibrium, the foreign exchange mechanism must, sooner or later, and more or less *automatically*, *make* exports

balance imports; and thus keep the balance of payments in equilibrium also.*

Hence, instead of approaching the problem of the exchanges in a small-minded and unstatesmanlike manner, as many people do, merely asking, "How can we get the exchanges stabilised?" one ought to ask, "What is the most efficient and least economically disturbing method of making exports balance imports and of keeping the balance of payments in equilibrium?" Correctors to disequilibrium must be found. Which are the best correctors?

6. *Methods of equating Exports with Imports.*

In actual fact there exist three, and only three, ways of securing equilibrium in the payment balance and of effecting the right ratio of exports to imports:

1. By deliberately controlling imports (perhaps via exchange rationing), and not permitting them unless sufficient foreign exchange to pay for them has already been (or is soon going to be) earned by exports. (Alternatively, exports might be subsidised.)
2. By having a fluctuating exchange which will depreciate if the demand for foreign money exceeds the export-earned supply—thus stimulating exports in the future, and checking imports.
3. By having a stabilised exchange, and an internationally transferable gold supply which will alter *internal* prices, via its reactions on the quantity of bank credit, so as to provide the necessary corrector.

There are no other methods, although it is possible to effect compromises between these three "correctors." Methods 2 and 3, it will be noted, can be made to work more or less automatically, without government intervention. Method 1 presupposes strict government control.

* The international payment balance and the import–export equation are not precisely the same thing, unless you regard receipts for cancellation of debt, and movements of fugitive capital, as imports. As I do in this book.

7. *The Case against Exchange and Import Control.*

The policy of deliberately controlling imports and exchange dealings (and perhaps subsidising exports) may at first sight appear the most effective of the three correctors, since it avoids fluctuations in *both* prices *and* exchanges. But the objections to it are considerable. It is the duty of governments to stimulate, and of the foreign exchange mechanism which they sanction, not to check, foreign trade. And yet if one nation grants import licences to its nationals only when other foreign countries have *already* bought sufficient of its goods to pay for the licensed imports, other countries will probably retaliate by granting import licences only when their own goods have *already* been bought by the first country. Such a process will, step by step, inevitably bring foreign trade to a standstill.*

This leaves us with the two alternative " automatic " correctors, namely fluctuating exchanges on the one hand, or fluctuating internal prices on the other.

8. *The Primary Function of the Foreign Exchanges is to cause Fluctuations in " Net External Prices."*

The essential function of these two " automatic " correctors to disequilibrium in a country's balance of payments, is somehow or other to make the goods of the debtor country cheaper to the nationals of the creditor country, so that exports from the debtor to the creditor may be automatically stimulated (possibly triangularly) in order that the previous deficit in exports may be made good. In other words, the function of the foreign exchanges is not to *prevent* fluctuation everywhere, as is frequently supposed, but positively to *cause* fluctuation *somewhere*, in order to bring about a change in " net external prices." It is quite impossible to over-emphasise this point, although it is customary for well-meaning bankers, who have

* Indeed, it is because the nations of the world have tried to interfere with the natural workings of the gold standard system, by imposing tariffs, quotas, etc., that international trade has virtually come to a standstill.

not studied the question, to advocate both internal price stability and stable exchanges (as well as non-interference by the Government).

9. *Alternative Methods.*

Now the only possible methods of changing net external prices, *i.e.* the prices of domestic goods to foreigners, are:

(i) By a movement in the exchange rate itself, coupled possibly with a more or less stable internal price level (the paper system); or alternatively

(ii) By a movement in internal prices, coupled with a stable exchange rate (the gold system).

One of the two is essential.* It is therefore impossible for a modern community to have the dual advantage of *both* stable exchanges *and* stable internal prices. Money *must* be unstable in value (*i.e.* " unsound ") either internally or externally (*unless* foreign trade is itself to be rigorously controlled, or, what is practically the same thing, unless the foreign exchange market is to be rationed).

10. *Is the expression " Sound Money " mere Clap-trap?*

These points, however, are habitually neglected by statesmen and even by bankers. They talk of sound money and seem to think that the exchanges can be freed from restrictions, and that both prices *and* exchanges can be kept stable by *sound* monetary policy. This, however, is entirely impossible. These unanalytic gentlemen are crying for the moon. Until banking is abolished or until there is only one great universal bank some good things in the monetary sphere will have to be sacrificed for the sake of others which are deemed even better. Instability of exchanges is the *price* of monetary stability; instability of money is the *price* of stabilised exchanges.

Alternatively, government interference with foreign trade

* We are here, *ex hypothesi*, excluding the third possibility of exchange controls, import tariffs and export subsidies.

and international finance is the *price* of trying to secure *sound* money, in both its senses.

The man in the street can, of course, see that fluctuating exchanges are disturbing, and that, other things equal, they tend to reduce the total volume of international trade and investment upon which the prosperity of Great Britain and other countries so largely depends. He therefore, seeing only as far as his nose, cries out, child-like, for stable exchanges. But although British prosperity may be *somewhat* upset by fluctuating exchanges, it may possibly be *even more* upset by the fluctuating internal prices which stable exchanges involve.

11. *The Statesman's Dilemma.*

Indeed, the main question at issue is *not whether* fluctuation is good or bad—for there has got to be fluctuation *somewhere* unless imports are controlled—but whether or not it is prudent for a government to sanction *and aim at* a policy, namely, that of the rigid gold standard, which positively requires and presupposes fluctuations in the general internal price level so as to secure equilibrium in the balance of payments.

A paper system permits (although it does not absolutely ensure) internal price stability. A rigid gold system positively prevents it. The political questions therefore at issue, are :—

(i) Are unstable internal prices less harmful for the nation than unstable exchanges, or *vice versa* ; or

(ii) Should attempts be made to secure both desiderata, by a rigid State control of imports, exchanges and international finance ?

The City hardly realises that a choice must be made between these alternatives. Nevertheless, these are the vital questions at issue.

12. *Monetary Ignorance.*

Actually, therefore, when an international banker pleads for stable exchanges he is indirectly pleading *either* for " un-

sound" (*i.e.* fluctuating) internal money *or* for State control of his own business, *i.e.* of international trade and investment, and the foreign exchange market. But does he realise it?

Similarly when a professor pleads for managed and stable *internal* money, he is automatically pleading for *unstable* exchanges (unless he simultaneously advocates import control and/or export bounties, coupled perhaps with a rationed exchange market). But does he ever say so?

Thirdly, if a politician pleads simultaneously for stable exchanges, sound money, *and* the removal of all exchange and import restrictions, he is merely demonstrating his ignorance of his subject, for he is irresponsibly asking for three incompatibles (unless he expects imports and exports always to balance by mere chance).

In fact any public figure who boldly advocates "sound money" as such, *without* any further qualifications, ought to suffer a feeling akin to shame; for he is ignorantly talking about something which possesses two opposite connotations.

And yet that is the state into which world economic life has recently sunk. Monetary questions are not studied except superficially, and decisions are made by persons who clearly have not studied their subject. No wonder there are millions of unemployed, living in an age where plenty becomes the cause of want, and where expansion habitually gives rise to reaction.

Nor, very often, are the defects of the gold standard appreciated at all accurately even amongst those ardent monetary reformers who state that they wish to abolish the gold standard altogether. They, as well as the gold defenders, are often at fault in their monetary analysis, and in their appreciation of the various problems at issue.

Every cabinet minister interested in unemployment certainly ought to have at his finger-tips the whole argument both for and against paper, and both for and against gold (even though he may not yet have made up his mind which is best); but the reader will agree that on talking these things over with men who should know, one rarely finds a banker or statesman

capable even of stating the two sides comprehensively—although the selfsame people will not hesitate to assert that either the gold standard or paper ought to be abolished.

13. *The Problem at Issue.*

The problem at issue is this: since there must be an international corrector which requires fluctuations *somewhere*: Would it not be better for the nation, instead of adhering to gold and making nearly all internal prices and profits move, merely for the sake of making only a few export prices move, so as to provide the *necessary* corrective changes in "net external prices," to adopt a fluctuating exchange system, meanwhile continuing to manipulate bank credit, but with a different end in view? That is to say, manipulating bank credit so as to keep the internal price level *stable*; instead of manipulating it so as to make prices *move?*

Under a gold system the prosperity of domestic trade is, via gold movements and credit policy, largely *governed* by events occurring abroad and by the haphazard action of foreign traders and investors. Might it not be better to adopt a paper system under which domestic monetary policy could aim at keeping the internal price level stable, so as to cure the business cycle and so as to avoid the subordination of domestic trade to foreign influences?

It is not merely the harm that the gold standard does, but also the good that it prevents, which makes a change of monetary policy seem to many desirable.

14. *Gold the best* "International" *System.*

Let me say this, however: Of all the alternative forms of *international* currency, gold, I think, is by far the best. Let me repeat this statement once and for all. Gold is by far the best *international* currency that the wit of man is able to devise at present. But please note I have used the word "international," and not "national."

A good international currency would be excellent; a bad one, however, is worse than no *international* standard at all.

In this book I am *not* advocating any alternative *international* standard. I certainly would do so if it were *politically* possible to have a *truly* international banking system. But at present this is not politically possible. Therefore I am advocating a *non*-international paper system. Let me say this once and for all: I am not advocating an *international* paper system.

The gist of my argument is broadly this: that even if people *would* work the gold standard properly, it would not be as good in practice as *non*-international paper; and since they will *not* work it properly, paper is much the best. Let us prove it.

ADDENDUM TO CHAPTER I (*Page* 14)

From time immemorial gold has been used as currency, and it is only in very recent years that its practical defects have become at all evident. This is almost entirely due to the recent refinement of the cash reserve ratio system of banking and note issue. It is in fact the imposition of a huge inflated pyramid of credit currency on gold currency which makes any small defect in gold itself, or change in the supply or demand for gold, of such magnified importance. It is this high ratio of "gearing," *coupled with* the fact that gold *is* an international *banking-reserve* currency, that makes the system less efficient than it used to be even fifty years ago.

Moreover, the refinement of bank credit and notes, although doing much good, has also led to the development of certain new monetary diseases (see Chapter XII); and these particular monetary diseases, although easily curable, cannot be cured *if* the supply of domestic money is to be dictated by international factors, instead of by domestic factors (of demand and supply). To argue therefore that since "from time immemorial" gold has always been found the best form of currency, it is therefore still the best, is to take no account of modern developments in banking and the use of notes.

As I have already said, if there were no banking system, or if there was only one *universal* bank, the problem of the foreign exchanges would not exist. The reason why it exists and why it has come to a head is because the banking and note systems have recently become *more* refined. I admit, of course, that the growth of war debts, coupled with the unwillingness of creditors to receive payment except in gold, has accentuated the speed of the maturity of the underlying diseases. But they were rapidly developing even before the

war, and it was only the peculiar Sterling Standard system, described in Chapter V, that kept the growing diseases from coming to the surface. Now, however, the sterling system has gone. That is why the problem is becoming, in practice, so vital.

WORLD GOLD PRODUCTION

(In Millions of Fine Ounces.)

	1929.	1930.	1931.	1932.	1933.	1934.
S. Africa	10·4	10·7	10·9	11·5	11·0	10·5
U.S.S.R.	1·1	1·4	1·7	2·0	2·8	4·2
Canada	1·9	2·1	2·7	3·0	2·9	2·9
U.S.A.	2·0	2·1	2·2	2·2	2·3	2·6
Australasia	0·6	0·6	0·8	0·9	1·1	1·2
World total	19·6	20·8	22·4	24·3	25·6	27·4
British Empire, % of total	72·0	70·2	69·6	69·4	64·8	59·2
S. Africa, % of total	53·2	51·4	48·6	47·5	43·0	38·2

Wherever, in the text, different figures from the above are given, they should be regarded as errata.

CHAPTER II

HOW EXPORTS ARE MADE TO BALANCE WITH IMPORTS

1. Short-sighted views.
2. Time-lags in the import–export equation.
3. Types of exchange transaction.
4. How the money-value of exports and imports must ultimately balance.
5. Temporary loans.
6. How the money used to buy imports is spent ultimately on exports.
7. Gold movements (temporary).
8. Popular objections to imports.
9. "Spending money out of the country."
10. The theory of the commodity counterpart of international loans, etc.
11. Triangular trade.

1. *Short-sighted Views.*

The question of the relationship between exports and imports is one on which there is much misapprehension. Take, for instance, the views of two Englishmen of noted integrity, both possessing in their own spheres the highest reputation for intelligence.

First of all, the leading British motor-car manufacturer: As I write he is reported to be saying, "Everyone who buys a foreign car puts an Englishman out of employment for a year."

Secondly, the Minister of Agriculture, Mr. Walter Elliot: He, rightly wishing to make British agriculture prosperous, puts on tariffs to shut out Danish competitive produce, and is applauded for so doing.

And yet the following slogans contain equal amounts of truth:

"Why buy British goods? Buy foreign goods and restore prosperity in Lancashire."

"Buy British and ruin the export trades."

"Buy British and reduce unemployment in England."

What the leading British motor-car manufacturer ought, I think, to be saying is: "Everyone who buys a foreign car prevents an Englishman from being employed in the English *motor trade* for a year. But his action gives virtually equal employment to some other man in some export industry instead; for when Englishmen spend pounds in buying dollars with which to purchase American cars, Americans and others will not part with dollars for sterling unless they want sterling; and sterling is useless to them unless they have bought, or are going to buy, English commodities or services. In fact, under a paper currency system, any sterling which Englishmen spend on dollars to buy American cars is eventually re-spent by Americans (or others) on some English export, visible or invisible."

Similarly, Mr. Elliot should consider, before he shuts out Danish produce, the equal mathematical reaction which his tariffs will have on the British export industries.

There is indeed in the highest places, in business, in the Ministry, and in the general Press, widespread ignorance on the whole theory of the relationship between imports and exports, and of the workings of the foreign exchange mechanism.

The position to-day regarding the foreign exchanges may well be compared with that existing three hundred years ago concerning the relationship between the earth and the sun. The expert authorities of 1635 could "see" that the sun went round the earth. They were "practical" men and naturally did not believe, or wish to believe, the fanciful theories of the academic Galileo. So to-day it is obvious to many of our Authorities that imports cause unemployment in Great Britain. It is also equally obvious to them that fluctuating exchanges upset foreign trade and investment. Therefore the cure must be equally obvious, *i.e.* to stabilise the exchanges and put on more tariffs. The experts of to-day, however, may be just as wrong as were the critics of "crazy" Galileo.

Under barter, of course, it would be clear that if we did

not import, our specialised export industries would suffer. But because our statesmen and leading industrialists have not seen fit to study the mechanism of foreign exchange—which they could easily do by spending a month in the foreign exchange market and then a few hours with any good text-book—they do not see that under a money economy the relationship between imports and exports is precisely the same as under a barter system.

As regards the foreign exchanges:

2. *Time-lags in the Import–Export Equation.*

Sooner or later, all imports must be paid for. If the debt incurred for imports is invoiced in foreign money, the British importer must buy foreign money, via the foreign exchange market, either from some British exporter who has already earned it abroad, or from some foreigner who wants sterling to buy British goods (or to pay for past goods already exported from Great Britain). The time factor, it is true, may be either past or future, but although the balance may not be immediate, it is clear that every import must sooner or later call forth a corresponding export of equal value.

Similarly, if the British importer has arranged to pay his debt in sterling, the foreign seller of the goods will eventually want to change the sterling back into his own currency. But no one (apart from currency speculators, and old debtors or new lenders to England—whose temporary influence we shall consider later) will exchange foreign money for sterling unless he wants to buy something in sterling; and this again implies a British export (past, present or future) whose value must equal that of the original import.

The essence of the matter is that, under a money economy as under barter, if something of value is bought from foreigners, something of equal value has got to be sold to foreigners. Stated in these terms, the truth of our contention is obvious. But under a money economy the existence of the foreign exchange market tends to confuse the issue; for money may

be temporarily exchanged for money and a considerable period may elapse before an import calls forth a corresponding export.

3. *Types of Exchange Transaction.*

In the foreign exchange market, demand arises not only from the importation of goods, services or securities, but also from the service of political and other debts, from desire to speculate in foreign currencies, from desire to travel, from the purchase of land, houses and factories abroad, from long and short term loans to foreigners, from presents and other remittances, and from a desire to export one's capital. Similarly, supply results not only from actual exports of goods, but also from the sale of securities, from the sale of financial, shipping and personal services, from dividends earned abroad, from short and long term borrowings, and from speculative purchase of currencies by foreigners (for a rise or for safety).

These are the constituents of demand and supply. Now let us consider the circulation of money used in the course of international trade and finance.

4. *How the Money-Value of Exports and Imports must ultimately Balance.*

If an Englishman buys an American car instead of a British one, American dollars will sooner or later have to be bought to pay the American manufacturers. Pounds, in fact, will be spent on dollars.

The American manufacturer might, it is true, temporarily accept payment in pounds, but eventually he himself will want to convert these pounds into dollars. Thus, there will arise sooner or later the problem of finding someone who will part with dollars in exchange for pounds; *i.e.* spend dollars on pounds.

American exchange speculators may temporarily perform this function, and buy the pounds, but sooner or later they too will want to take their profits or losses, so that the influence of speculation is only temporary. Eventually the speculative

buyer of pounds will want to re-convert them into dollars once more; ultimately, therefore, a *bona fide* trader who wants to part with dollars in exchange for pounds must be found.

But the only person who will permanently spend dollars on pounds is someone who wants to buy British goods, *i.e.* to import from Great Britain. Indeed, in the long run, any pounds initially spent on dollars (for example, to buy imported American cars) must sooner or later be re-spent on British exports. Eventually, in fact, exports must equate, in sterling value, with English imports.

5. *Temporary Loans.*

Temporary dollar-loans, to enable Englishmen to pay the American manufacturers for their cars, can, of course, delay the exportation of English goods to pay for the imports; but when the loans are repaid, sterling will have to be spent on buying the requisite dollars; and buyers of sterling (*i.e.* sellers of dollars) will be found only if there are Americans (or other foreigners) * who wish to purchase English exports.

If, during the currency of the temporary loan, the dollar slumps in relation to the pound, the required number of dollars will be bought with a smaller number of pounds, and a smaller sum in sterling will eventually be spent on English exports. But, apart from these interim exchange fluctuations,† the money value of English exports (visible and invisible) must ultimately equal the money value of the imports.

Even if actual English bank-notes or currency notes flow abroad to pay for the imported cars, and are held there for some while, they, since they are not spendable in America, will later come on offer in the foreign exchange market ‡ to

* See Chapter VIII for triangular equations.

† Which are unlikely to be permanent, unless inflation is occurring in the currency used for invoicing.

‡ The foreign exchange market is not a place, but a series of offices in different banks and other buildings, both at home and abroad, all in touch with each other by telephone.

be exchanged for dollars; so that a buyer of sterling will equally have to be found who is anxious to part with dollars to buy something English.

6. *How the Money used to buy Imports is spent ultimately on Exports.*

Ultimately, therefore, each import will be married to an equivalent export. Indeed, in the long run, the exports of Great Britain pay for the imports; and the export trades are merely selling their goods for the same amount of English money that English importers spend on foreign goods.

What the importers pay the exporters receive, less only a few small commissions. Monetarily speaking, the two groups merely trade with each other with a lag, at one or more monetary removes, *i.e.* triangularly or quadrangularly, etc.

7. *Gold Movements (Temporary).*

In regard to the purchase of American cars, it may be argued that gold is sometimes exported to pay for the cars. This is true. And in so far as this happens, gold is the corresponding export, at all events temporarily. But gold is only exported when the balance of payments is already adverse. Moreover, its movements should have the early after-effect of raising American prices, and of lowering British prices, so that British exports are encouraged and American exports discouraged. Indeed, gold merely performs the function of *causing* commodity exports eventually to balance with commodity imports. When the balance has been restored, and slightly exceeded, the exported gold should flow back. Gold movements, in fact, should be only temporary, unless some permanent international disequilibrium in gold prices and gold holdings has developed.*

In the long run, gold exports are of small importance in international trade, except in the case of the gold-producing countries. Most of the other balances are settled in com-

* See Chapter VIII on Purchasing Power Disparities.

modities (or securities, tourist amenities or services) which are set in motion by means of (temporary) gold movements.

In the long run, therefore, importation is impossible without a corresponding exportation, for the exports pay for the imports, and *vice versa.* To check importation is therefore ultimately to check exportation (or the payment of interest on old foreign loans); and to check exportation is to check importation.*

8. *Popular Objections to Imports.*

English car manufacturers may, of course, feel aggrieved when their compatriots buy foreign cars; but the English buyers will feel that they are getting better bargains from such purchases (and that is the English car manufacturers' fault). Moreover, some corresponding English export industry will benefit *equally* sooner or later,† so British statesmen, as distinct from British car manufacturers, need not be disturbed.

This is the simple equation (i) of "international trade" and (ii) of the triangular dealings (via the exchange market) between the import and the export industries. Shut off future imports and you inevitably cause a reduction of future exports. In the long run, if imports are shut out, the English demand for foreign money will decline, and even if exports continue the same in volume *for a short while*, the increase in the export-earned supply of foreign money, coupled with the declining import-demand for it, will *eventually* raise the price of sterling abroad and, under *paper*, check exports immediately; or, under *gold*, will do so as soon as the consequent gold movements have had time to raise English internal prices and/or lower internal prices abroad.

Thus the policy of shutting out imports will eventually

* The question whether imports govern exports, or *vice versa*, is discussed in Chapter IV.

† Unless the dollar slumps in the interim, which, other things equal, is unlikely; particularly if American goods are more attractively priced at current exchange quotations.

damage some domestic export industry. The adjustment may admittedly be slow, but it is nevertheless inevitable.

It may seem sound statesmanship, *at first sight*, to shut out all non-essential imports and "to produce them ourselves so as to give *more* employment to British labour," but the export industries will suffer correspondingly in future, to an almost exactly equal monetary extent.

This matter is the subject of so much popular confusion, even among international bankers, that it must be given our further consideration; especially since statesmen, misled by fallacious reasoning, often adopt policies which hurt their own countries despite their sincere desire to benefit them.

9. *Spending Money out of the Country.*

Although we have shown that all imports eventually involve an exportation of equal value, it is customary for patriotic people, when Englishmen start buying foreign cars, to accuse the importers of unpatriotically "spending their money abroad" and employing the foreigner "at the expense of the Britisher."

In fact, a large mass of people object to imports on the ground that they deprive British workmen of jobs, and British capitalists of profits, while possibly leading, under the gold standard, to a loss of gold if the international payment balance should already be adverse.

Under the gold standard there is certainly something to be said for this argument; for under the gold standard gold money is sometimes exported in partial settlement of an adverse balance; but under a paper system no money leaves the country at all, for, since it does not circulate abroad, it is useless to send it to some other country. What happens when the country is on a paper standard is discussed below. It will be seen that, under a paper system, the so-called practice of "sending money out of the country" does not harm British employment at all.

If an Englishman buys an American car instead of a British

one he is certainly supposed to be spending his money abroad, and reducing the amount of employment in, say, Oxford or Coventry; and naturally people who know nothing about the theory of foreign trade, nor the mechanism of the exchange market, are inclined to regard this as unpatriotic.

If, however, such persons would spend a month or two in the foreign exchange business and keep their eyes open (although many bankers have spent years in the market without ever seeing what was actually going on) they would soon realise that when an English buyer of American cars, or his agent, enters the foreign exchange market and buys the necessary dollars, he, or somebody in the exchange market on his behalf, has got to find someone who is willing to sell dollars and buy sterling. Apart from temporary speculative transactions and temporary loans, which we have already discussed, the only people who are ever willing to part with dollars for pounds are:

(*a*) People who have *already* exported goods to America and want to cash the proceeds back into sterling; or
(*b*) Americans * who are buying sterling because they want to spend money in England; or
(*c*) Americans who want pounds to pay an old debt in England.

In the case of (*a*) and (*c*) an export has already occurred, which has got to be, and ought to be, paid for; and employment has *already* been given to British workmen. In case (*b*) employment is going to be given either in connection with some English commodity, which will be bought by and exported to an American, or on such things as an American traveller will purchase in Great Britain if he is buying sterling to spend here himself.

The simple mathematics of the foreign exchange market are such that every time an "unpatriotic" buyer of

* Triangular deals are dealt with in Chapter VIII.

American cars spends an English pound on buying dollars, he (or his exchange dealer) must find some equally unpatriotic American (or other foreigner) who wants to part with dollars to buy a pound in order to purchase English goods and services. No money leaves either country at all: its ownership is merely changed internally via the foreign exchange market. And although money may be definitely diverted by the transaction from the English motor trade, its expenditure is switched over to some other industry.

English money spent in the foreign exchange market is, in fact, not spent *outside* the country at all, but is sold to somebody who is going to spend it *inside* the country; just as the dollars which are bought abroad, instead of being spent in Great Britain by the American who parts with them, are spent in America by the English buyer thereof who is going to purchase an American car.

The point is that under a paper currency standard it is really a misnomer to say that money is spent outside the country at all, for in actual fact it is spent inside the country on foreign currency. And this transaction, which is essentially an exchange transaction, merely means that an American, perhaps a tourist, is going to re-spend the English £'s in England whereas an Englishman is going to re-spend the American dollars in America, and the same value of consumer-spending takes place in *both* countries.

The distribution of monetary expenditure as between different industries is, of course, affected. Oxford suffers and Mayfair hotels perhaps benefit, and in America Detroit benefits and Fifth Avenue suffers.

But there is no need whatever for politicians, under a paper standard, to worry about Englishmen importing too many foreign cars, etc. Oxford, I repeat, may suffer, but some other English area will *inevitably* benefit. The balance is almost as perfect as in a mathematical equation.

"Unpatriotic" Free Traders who propound this theory (and whom their opponents accuse of "caring nothing about

the British unemployed ") cannot, of course, say precisely *which* particular English export industries will eventually benefit from the importation of American cars—and this is why their case is rather unconvincing compared with that of the Protectionists—but that some industry or other will benefit is indisputable.

The only exception to this rule is, if foreigners buy English money (when they part with their own currency) but *never* spend it in England; in which case we get a foreign car for nothing, provided that the British money purchased is paper instead of gold! But no foreigner would buy English paper unless he wanted to spend it, so this case of " eternal hoarding " does not arise in practice.

Anyone in business in the foreign exchange market can (if he wants to and is not blind) see all these precise mathematical equations working themselves out right under his nose.

Moreover, Englishmen will not buy American cars unless they think they get better value for money, and if America is really a more efficient producer of cars than Oxford or Coventry it is much best for the Oxford trade to decline and for some other English industry, which is " really " more efficient from the competitive international point of view, to be fostered, and enjoy, from Americans (directly or triangularly), business which Oxford does not equally deserve.

10. *The Theory of the Commodity Counterpart of International Loans, etc.*

If an Englishman buys Swiss francs (either for Alpine sport or for the purchase of a chalet in Switzerland), or if an Englishman lends money to Switzerland * (*e.g.*, finances the construction of an hotel), then there must ultimately be an exportation, of equivalent sterling value, from this country.

The sterling which is lent will, *ex hypothesi*, be spent on Swiss francs; † and the only possible buyers of the sterling

* This is often called " importing an I.O.U."

† If some of it is spent locally on English steel, the steel is the corresponding export.

will be foreigners,* who want to spend money in England to pay for (past or future) English exports (visible or invisible); or to pay off some past sterling loan, which gave rise to a commodity export when it was first contracted.

In any case an export leaves England † and the monetary loan has a commodity (or service) counterpart of equal monetary value.

11. *Triangular Trade.*

The English export need not, of course, go direct to Switzerland: instead, English exports may go to Italy and Italian exports to Switzerland. Or, in other words, English exports may be exchanged for Italian goods, and the Italian goods exported to Switzerland.

In this case sterling is spent on lire and sold to Italians who want to buy goods from England; and the lire are then spent on Swiss francs and sold to Swiss who want to import goods from Italy.

The net result is—going right back to our original sterling loan made to Switzerland—that the Swiss francs which the Swiss borrower buys (directly or triangularly) with the proceeds of his sterling loan are spent by him in Switzerland. Meanwhile (or rather in the long run) there will be an exportation from England equal in value to the sterling loan, and an importation into Switzerland equal in value to the Swiss borrowings.‡

* If an English exporter, who has already sold goods for Swiss francs, is the converter of Swiss francs into sterling, the export will, of course, have *preceded* the importation of the new Swiss I.O.U.

† The *ownership* of the export leaves England, but the actual commodity or service need not: to wit, the purchase by Swiss of restaurants or tourist amenities in England.

‡ More will be said on Triangular Trade and Triangular exchange dealing in Chapter VIII.

CHAPTER III

WHY IT PAYS A NATION TO IMPORT

(The Theory of International Trade.)

As already stated, it is often contended by patriotic politicians, whose desire is to relieve unemployment in their constituencies, that it is wicked to import foreign food, cars, etc. when unemployment exists in, say, agriculture or the motoring industry. Foreign imports, they say, should be shut out to the benefit of domestic employers and workers.

Such a contention would, of course, be true if imports did not give rise to corresponding exports, and if the importation of goods of a given value did not give employment and profit to an equal * value in corresponding export industries.

We have already explained how this works out in terms of money values, via the foreign exchange market, but some additional remarks are possibly needed in terms of the real benefits derived from international trade.

Foreign trade is but one application of the principle of the division of labour. Each nation should produce those things which it can produce to the greatest advantage, just as each individual should be put to the work he can do best. As Adam Smith said, very good grapes can be grown in Scotland, and very good wine can be made from them, but at about thirty times the expense for which at least equally good can be brought from foreign countries. It is therefore to the advantage of Scotland to import wine and to pay for it with something like whisky or steel goods, for whose production Scotland is better suited.

This advantage of the international division of labour some-

* This refers mainly to a paper currency standard.

times produces the puzzling anomaly that it may actually pay a country to import something from abroad which it could produce more cheaply at home. For example, it pays England, reputed to be the finest dairy country in the world, to import dairy produce from Denmark, paying for it with coal and manufactured goods. The point is that, although England can probably produce butter, etc. more cheaply than Denmark, England has a *still greater* advantage in the production of coal. It therefore pays her to devote herself to that branch in which she has the *greatest* advantage. As Mr. Todd puts it, it might pay an individual to buy from others something which he could make better or more cheaply himself, if by doing so he could devote himself to some other branch of production in which he has an even greater advantage.

The theory of international trade is therefore that each country should produce, not merely what it can produce *more cheaply*, but what it can produce to the *greatest* advantage. This is known as the Law of Comparative Cost. What must be considered is not the cost of producing *each single commodity* in *England*, as compared with its cost of production abroad, as the simple might think, but rather the comparative cost in the two countries of producing the *two* commodities which might be exchanged. Thus, as Todd says, if in one country, X, a commodity A costs five units of labour and capital to produce, and another commodity B costs ten similar units in X; while in another country, Y, the production of A costs only three units of labour, etc., against nine for B, then Y should devote itself entirely to producing A and leave B to be produced in X (although Y can actually produce B more cheaply than X can), because the comparative cost of A to B in Y is 1 : 3 against 1 : 2 in X. Thus 100 units of A produced in Y and 100 units of B produced in X will cost altogether only 1,300 units of labour and capital. By any other distribution the cost per unit of output would be increased.

Another way of expressing the same truth is as follows (and I here quote from Bastable). Let A and B be two nations,

x and y two commodities. Let it be assumed that each nation has two units of productive power, each of which can in A produce 2 x or 3 y, in B x or 2 y. Then, if there is no interchange, the total production will be $3x + 5y$, while if each country confines its production to that commodity in which it has the greatest relative advantage, the total will be $4x + 4y$. Actually it is quite evident that x costs more than y, since more productive power is needed for its creation (viz. in A, $\frac{1}{2}$ unit against $\frac{1}{3}$; in B a whole unit against $\frac{1}{2}$). Therefore it is expedient for A to produce x only, and for B to produce y only. It is, however, evident that A has superior facilities for the production of *both* commodities; nevertheless, it should import y, exporting x in exchange. Compare England and Denmark as regards dairy and coal products.

Hence, although it seems wicked at first sight to import dairy produce from Denmark when English agriculture is depressed, it becomes apparent on second thoughts that if the import of dairy produce were prohibited some English export industry, perhaps coal, would suffer; for England's exchanges would appreciate and make English coal dearer to the Danes, who would probably then import coal from Germany or Poland. Since England has a greater relative advantage over Denmark in producing coal, it is better for English economy (and incidentally for Danish as well) that England should go on importing dairy produce from Denmark instead of trying to keep up her own agricultural employment by producing it at home. The apparently laudable scheme would undoubtedly result in virtually equal unemployment in, say Newcastle; and England and Denmark would both be deprived of the real gains which result from exploiting the potentialities of international division of labour to the full.

Like many other sound principles in economics, this is shocking to the untutored "patriotic" mind. But what "appears" sound on the surface proves unsound and untrue, provided a little thought is expended.

The politician who wishes to shut out foreign food must

explain, assuming it was not previously given away by the foreigners, the "real" manner in which it was previously paid for; and he must prove that if the imports are shut out, some export industry will not equally suffer.

If, under a gold standard system, the volume of imports is too large, it is true that gold will be lost and credit deflation may ensue; but under a paper standard the argument cannot be sustained on economic grounds.

On political grounds a case may be made for tariffs for revenue purposes; for fostering infant industries; for increasing diversification of production; for fostering an outdoor rather than an indoor life; for being self-sufficing in case of war, and so on. But this is departing from the realm of pure economics to that of national policy.*

* A case for *temporary* tariffs can also be made against pure dumping and against certain types of exchange-dumping due either to the deliberate undervaluation of a gold currency by a foreign government, or to a foreign country inflating its paper currency, and its exchanges falling temporarily even faster than internal prices are inflated. But such tariffs usually become permanent!

CHAPTER IV

TARIFFS AS A CAUSE OF BAD AND GOOD TRADE

1. Permanent export surpluses are impossible.
2. Do our imports govern our exports, or *vice versa*?
3. Generalising the particular: an economic fallacy.
4. A damaging form of patriotism.

1. *Permanent Export Surpluses are impossible.*

Of all the economic subjects on which delusions exist, Protection and Free Trade carry the field. Imports, it is agreed, must be paid for by exports; but every country is trying to shut out imports, and yet at the same time to stimulate its exports. All want to sell (and be paid) without buying, which is patently absurd. The result is obvious: international trade is disappearing. If a country wants to export it has also got to import; and under paper currency (and under gold too, to some extent) imports stimulate exports. Why, therefore, try to shut imports out when you want to stimulate exports—or is there some other factor which we have overlooked, yet which justifies two such apparently incompatible policies?

We have already stated in Chapter II, that under paper currency any English money spent on importing foreign goods is spent at one or two removes on English exports, and that the two quantities are an exact equation, bar a few deductions in the form of exchange dealers' commissions.

Exports, in fact, must equate monetarily with imports; the former pay for the latter.

Any decline in imports must therefore lead, though possibly the time-lag may be considerable, to a decline in exports; and any increase in exports (unless loans to foreigners are made) must lead to an increase in imports.

It is impossible for any one country, or for countries as a whole, ever to have a permanent excess of exports (or imports), visible and invisible, unless international defaults occur.

The question, therefore, arises: If a country like Great Britain, either for purposes of revenue or in order to reduce unemployment, puts on a tariff which shuts out imports, will the export trade suffer to an equal degree in consequence?

The answer in all probability is "Yes"; although it is not an absolute certainty.

2. *Do our Imports govern our Exports or* vice versa?

The real question at issue is: Is it our importation from foreigners which limits our exports; or is it foreign buying of our exports which limits our imports? In other words, do our imports govern our exports, or our exports govern our imports? The answer, as it happens, depends on "the elasticity of foreign demand."

If, despite our new tariffs, and the temporary shutting out of imports, foreigners insist on purchasing the same amount of English exports as formerly, *despite* the probable increase in price which will result in the first place through the improvement in sterling due to the shutting out of foreign imports, the eventual increase (as measured in terms of foreign currency) in the demand for the now dearer sterling will raise its price in the foreign exchange market even more and make foreign goods cheap again to Britishers despite the tariffs; this will stimulate English imports from abroad once more; thus instead of British exports falling *pari passu* with reduced imports, there will, after a time-lag, be an increase in imports again, and international trade will be much the same as before. Imports will, in this case, not have governed exports; exports will have governed imports. The tariffs, in fact, will have proved ineffective from the point of view of stopping foreign competition (as distinct from producing revenue).

Everything clearly depends upon the insistence with which

foreigners demand English products regardless of their price: *i.e.* on the elasticity of their demand.

Unfortunately, however, most foreign demands for our products are elastic, and any increase in the "net external price" of British goods (as a result of exchange movements due to the shutting out of imports) will diminish the foreign demand for British goods, and exports will fall *pari passu* with imports.

This, however, is not *absolutely* inevitable, as so many Free Traders seem to think.

3. *Generalising the Particular: an Economic Fallacy.*

One of the commonest faults among amateur economists is to arrive at *general* conclusions as a result of their own individual experiences. For instance, in 1931 a well-intentioned book was written by a leading newspaper magnate to show how, if general Protection were adopted in England, industry after industry would benefit. The author having proved his case for almost every manufacturing and raw material producing industry in the country, then concluded that what was true of each part must therefore be true of the whole. This "logical" method is dangerous in economics. The fact is that if a whole mass of imports are shut out, thus benefiting a whole series of industries, a whole mass of exports will also, almost certainly, be shut out eventually, so that industry as a whole will probably gain nothing. The burden of trade depression will merely be shifted from those industries formerly subjected to foreign competition to certain export industries (difficult to name in advance) for whose products foreign demand is elastic, which may possibly be *more* depressed and therefore require stimulation *even more* than the industries subjected to direct foreign dumping.

Indeed, the whole "Buy British" policy rests very largely on an economic fallacy.* If British holiday-makers go to

* In saying this I am not attacking Empire Free Trade and Empire development. I am merely attacking the fallacy that, under a paper currency, imports are harmful to the nation *as a whole.*

English resorts, or if British consumers buy British rather than foreign goods, the consequential decline in imports may hurt our export industries. The probable economic consequences of buying British are merely to increase the prosperity of certain home trades *at the expense* of certain exporting industries (although we have already shown that it is theoretically just possible for exports not to be hurt at all if the foreign demand for British goods is entirely inelastic, which in practice it never is!).

If politicians and publicists, before jumping to conclusions that if imports are causing unemployment in certain home trades, unemployment *as a whole* will be reduced by shutting out the imports, would:

(*a*) Spend a year in the foreign exchange market, and learn that it is, in fact, an "exchange" market and that foreigners spend in England every pound we spend on buying foreign money to spend abroad, and

(*b*) Ask themselves how £100 (paper as distinct from gold) spent on visiting a Swiss hotel can be spent in any way outside England—which is merely the converse of asking how 100 Swiss francs can be spent at Brighton,

there would not be so much nonsense—plausible to the ignorant—talked about the national benefit to trade to be derived from tariffs.

4. *A damaging form of Patriotism.*

For revenue purposes tariffs may be excellent: to foster infant industries they may be desirable: for reasons of defence and culture (*i.e.* more diversified employment) they may be good policy. They may also be good under a gold currency system to check gold exports and thus prolong the period for which a country may remain on gold, or refrain from deflating credit currency internally. But to think that foreign competition under paper currency damages British trade *as a*

whole is to forget (i) that foreigners spend here exactly as many pounds on our goods as we spend on theirs, and (ii) that if some consumers are charged less for foreign goods, they will have more left over to spend on other English things; and trade *as a whole* need not suffer.

We should also add that to think that the 10 per cent. tariff imposed on British imports by the National Government in 1932 will improve British trade * as a whole because it shuts out foreign goods, is to close both eyes to the fact that so long as we are on a paper currency, the foreign price of which will improve in the foreign exchange market (unless it is artificially controlled) *pro rata* as we reduce our imports, it will lead to a check to exports and a re-stimulus to imports which will soon negative the initial benefit to trade of the tariff.

To impose such a tariff on a fluctuating paper currency basis *for revenue purposes* is reasonable. To think that it will improve *total* trade is sheer nonsense; † for directly it begins to be effective, the exchanges will (unless artificially controlled by an Exchange Equalisation Fund) soon move in our favour and immediately ‡ wipe out the benefit.

> [Since paper exchanges swing and largely jump tariff walls, this is one reason why areas like Central Europe, whose prosperity is being ruined by tariff walls, which in each country it is *politically* impossible to reduce, should perhaps abandon gold, and adopt paper which will jump the tariff walls and thus reduce their restrictive effect. It is, moreover, worth while pointing out that if Japan, under a paper system and because of her low labour costs of production, is undercutting rival British manufacturers at home or abroad, the surplus Japanese exports will soon make the Japanese exchange so " favourable " that the net-external cheapness of her goods will soon be

* There is, of course, a *temporary* stimulus to the constructional industries while new plant is being (wastefully) set up.

† Except for the short while before the exchanges begin to move.

‡ Unless an Exchange Equalisation Fund is used to keep the pound down.

wiped out (see Chapter XVII) unless she re-lends her surplus credits abroad.]

At first sight, of course, all this may seem rather far-fetched and ridiculous; but, as is so often the case in economics, the first impression is erroneous.

To the amateur economist it may seem obvious that if foreign goods are upsetting dozens of English industries, British trade will be revived by shutting them out; but to argue from the particular to the general in this way is a fallacy.* National industry *as a whole* is not damaged by imports, nor benefited by their exclusion, for trade is merely a process of exchange. Tariffs alter the direction of trade activity; but in so far as they foster the growth of industries for which the country is ill suited (for instance, the growing of grapes in Scotland), tariffs are economically harmful to the nation, for they wipe out the real economic benefits of international trade.

I know that no amount of repetition of these theoretical truths will ever convince the ardent Protectionist that there is not some practical "snag" in them; nor will he as a "practical" man be seduced by "mere economic theory." But if the reader desires a lucid exposition of "Protection and Free Trade" let him send to the Hogarth Press, 52, Tavistock Square, London, for the pamphlet † written by L. M. Fraser, which contains an entertaining refutation of most of the nonsense talked not only by well-meaning Protectionists but also by patriotic Free Traders.

* The Fallacy of Composition.
† Price 1*s*. 6*d*.

PART II

MECHANISM OF THE GOLD AND PAPER EXCHANGES

CHAPTER V

THE THEORY OF THE GOLD STANDARD

1. *The Seven Different Types of Gold Standard.*

The expression "The Gold Standard," instead of having only one precise meaning, conveys a whole medley of different ideas. There are, in fact, seven different forms of the Gold Standard.

First, there is the Gold Coin Standard, under which gold coins circulate internally, as in England before the War and as in the United States until the spring of 1933.

Secondly, there is the Gold Bullion Standard, under which actual coins are withdrawn from circulation, although gold bullion is available for use in the arts or for export, thus maintaining all the money of the country at gold parity. Legal tender notes are redeemable on demand in gold bars instead of gold coins. An economy of gold is thus effected without divorcing the monetary system of the country from that of the rest of the world.

Thirdly, there is the Gold-Exchange Standard, which implies no gold coins in internal circulation and no redemption of paper money in either gold coin or bullion. Such internal money is, however, convertible on demand into balances in some on-gold country abroad. The pre-war Indian currency was managed on this gold-exchange system, which implies that if the country in question is having its supply (*i.e.* buffer

stock) of foreign balances eaten into too fast it deflates, so as to stimulate commodity exports wherewith to augment its foreign balances.

A conceivable variation of this gold-exchange method would be for a government, although not prepared actually to redeem its legal tender notes in drafts on gold deposits or on balances held abroad, to keep the market quotations for its paper currency pegged in terms of foreign on-gold currencies by means of an Exchange Equalisation Fund; so that the country would (temporarily) get all the benefits of the gold standard without actually being on the gold standard proper, or even on the authentic Gold-Exchange Standard. This system, however, unlike the Gold-Exchange Standard proper, is likely eventually to get the exchange authorities into difficulties, *unless* the country adopting it has a regular export surplus. Deficits would require internal deflation.

Fourthly, there is the Variable Gold Standard, which, although not yet tested in practice, seems likely to be tried out in the future. Under such a system the internal statutory price of gold would be varied from time to time, somewhat as the bank rate is varied, being raised if the demand for foreign currency was exceeding the supply; and *vice versa*. The exchanges of the country in question would depreciate when the price of gold was raised, thus acting as a stimulus to exports and a check to imports. Conversely, the price of gold would be lowered if the export surplus appeared to be getting too big.

It is also possible to operate a paper variation of the "variable gold standard." By means of an Exchange Equalisation Fund, a government could, if it wished, sell foreign exchange at a temporarily fixed price, while at the same time retaining the right to vary the price according as demand exceeded supply at the old price, or *vice versa*. Just like a retail shop.

A fifth system is the Rationed Gold Standard, as operated by Germany in 1933. Under this system foreign balances are sold to importers by the government-controlled Exchange Market only if a sufficient supply has already been, or is about

to be, earned by exports. The system virtually means the rationing of foreign exchange, which indirectly has the effect of regulating the importation of goods (and the exportation of capital) by a system of licences.

Various refinements of this method can be adopted by the Control, such as quoting different prices for a given foreign money according to the nature of the import; *e.g.* a very high price for non-essentials like diamonds, and a very low price for essential raw materials. Special prices might also be paid to different types of exporters for the foreign money which they earn: a high price might be paid for exports which it was wished to encourage and a lower price for those which it was desired to discourage. It would even be possible for government bounties to be given to exporters; or for the taxes collected on imports to be earmarked for bounties on particular exports. Foreign tourists can also be given cheap rates.

Sixthly, there is the " Controlled Sterling Loan " type of gold standard as operated by England before the War. While, seventhly, there is the Authentic Gold Standard.

These last two forms of the gold standard will now be discussed.

2. *The Pre-war Sterling Standard.*

A rigid gold standard can, as it happens, be worked in two entirely separate ways.

In London before the War the operation of the gold standard was on the basis of a " Controlled Sterling Loan Standard," as follows:—

America was then a debtor country; France was a creditor nation, but tended to impede gold exportation. London, in fact, was the only great free gold market. London, moreover, was the world's central banker, and the international banks in London held large balances on behalf of the traders of all foreign countries, and credited and debited their accounts with any surpluses or deficits falling due between them. The gold standard was, in fact, before the War, very largely a

sterling standard, where London was used both as Central Banker and Clearing House.

England, moreover, as a result of a long sequence of overseas investments, had a large favourable payment balance falling due to her annually on foreign income account. Being internationally-minded, however, and having habitually made profits * from overseas investments, she habitually re-lent † these surplus interest payments and did not demand payment in gold. Indeed, if gold came to London in excess of banking and currency requirements, the Bank of England rapidly lowered the bank rate; money was thus made cheap and plentiful in London, and foreigners were encouraged to borrow; no objection was made to their transferring all or part of what they borrowed in the form of gold.

If, on the other hand, through temporarily excessive lending abroad, too much gold was being taken from London, the bank rate was raised; foreign borrowing in London was thereby discouraged, and the normal favourable balance of international income payments soon replenished the London stock of gold.

Thus, the English surplus on current international income account was used, according to the needs of the time, either to build up our gold reserves or to provide accommodation to debtor countries to develop their economic resources.

Even if other countries got into debt with each other they often settled, not so much by gold exports to each other, as by transferring their sterling balances in London, or by borrowing in the London market, which settled in its books their foreign debts for them. Internal prices, it is true, sometimes moved slightly because of gold movements, but gold movements and movements in internal prices were largely ironed out by varying sterling loans; the system was, in fact, a kind

* As we shall show in Volume III, these profits were imaginary rather than real, since they were not encashable, although they existed on paper.

† Visible imports admittedly exceeded visible exports, but invisible services, rather than interest on loans to foreigners, made up the annual balance.

of British-controlled "World Exchange Equalisation Fund," operated by turning on and off the tap of sterling loans.

The system worked satisfactorily (*a*) because England had a large annual surplus income from foreign investments and (*b*) because the Bank of England manœuvred the bank rate wisely. Gold as metal was not hoarded by England, and the international distribution thereof was reasonably maintained.

* * *

Now although this was the way in which, in practice, England happened to work the "manipulated gold-loan standard" before the War, solely because of her peculiar and special circumstances, the fundamental theory behind the gold standard is, actually, quite different; and this fundamental theory must in practice be applied in all cases where the chief creditor country is not, as to-day, (*a*) a willing foreign lender and (*b*) an international banking centre and Clearing House.

3. *The Authentic Gold Standard.*

In pure theory the gold standard should be worked strictly as follows:

If one country owes another more money than it has earned abroad with its exports,* the price of the creditor country's currency rises in the foreign exchange market of the debtor country until it reaches the gold export point; gold then begins to flow abroad so as to settle the balance. This weakens the cash position of the debtor country's central bank, and the bank rate is consequently raised.†

The first effect of the higher bank rate in the debtor country is to attract short-term funds from abroad so as to earn the now higher rate of interest. This fund of short-term foreign money, placed on offer in the foreign exchange market, is, in the short run, the supply which *temporarily* makes good the

* Perhaps because its internal price level is too high, and imports exceed exports.

† If the banks hold surplus gold reserves there may, of course, be a time-lag. If, however, the banks are fully loaned-up, immediate action will probably be taken.

initial real shortage of exports and of export-earned foreign currency.

There are, however, other reactions which later provide a more permanent corrective.

First, the raising of the bank rate within the debtor country depresses securities on its Stock Exchange and thus makes them more attractive to foreigners; securities tend to be exported, and more foreign currency is probably thus earned.

Secondly, the rise in the bank rate, coupled usually with restrictive open-market operations by the central bank, causes bank credit to be deflated in the debtor country (in addition to being made dearer), and when this happens the prices of commodities (as well as securities) tend to fall. Commodity exports are thus encouraged, while imports are checked; and the adverse balance of " real " trade is corrected.

Thus, in the short run, deficits in the balance of payments are made up either by actual gold exports, by a supply of short-term investment funds from abroad, or by the sale of securities. In the long run, however, it is goods that ultimately correct the balance. It is the change in the relative internal price level, *i.e.* in net external prices, which finally brings about the goods equation.

These are, or should be, the influences in the debtor country. Converse influences should operate simultaneously in the creditor, or gold-receiving, country.

While bank rates are being raised, and while credit and prices are being deflated, in the debtor country, they should be respectively lowered and inflated within the creditor or gold-receiving country. An efflux of short-term money should thus in the first place be stimulated, and the rise in prices of both securities and commodities in the creditor country should check the exports thereof, and stimulate foreign imports, so that the " favourable " balance of payments of the creditor country is diminished.*

* *N.B.*—When debtor countries deflate and creditor countries inflate, purchases of commodities by the debtor from the creditor decrease not only because prices are higher in the creditor country, but because incomes themselves decline in the debtor country, and the unemployed and others consume and import less.

In other words, if one country owes another more than it has earned, gold should move, and the resultant *bilateral* (not unilateral) change in the two internal price levels should soon correct the previous disequilibrium. Goods, in fact, should flow in the wake of gold to the creditor countries, who should clearly not impose tariffs to exclude them.

Eventually goods should flow in sufficient quantity to compensate the original export deficit (temporarily made good by gold exports and short loans); the exchanges of the original debtor country should then once more appreciate; the original gold should then flow back, and short-term money rates in both countries should once more alter. The owners of the temporarily loaned money should then repatriate it—*i.e.* spend it on re-buying their own national currency. The temporarily borrowed foreign money in this manner is repaid. Equilibrium is once more found—until at last some new disequilibrium, perhaps in the opposite direction, causes the sequence to be once more repeated.

Gold should only remain permanently exported if, at the old relative levels of internal prices, international tastes are such that a permanent surplus of imports matures. If this is the case, the price level of the debtor country must be permanantly lowered, which is effected by the *permanent* export of gold.

4. *The Bank Rate Weapon.*

In operating the gold standard the bank rate is important; for in so far as there is an international supply of short-term loan money seeking the highest possible rate of interest, the raising of the money rate in one centre should attract funds from abroad, thereby making good, in the foreign exchange market, the deficit which has matured on ordinary export-import account.

Sometimes, however, a higher bank rate is ineffective in attracting funds from abroad; in such cases more gold has to be exported than usual, since the normally expectable supply of short-term loan money is not immediately forthcoming.

But the movement of a bank rate has additional effects beyond that of merely inducing foreigners to offer their currencies in the foreign exchange market, thus making good the deficit in the export-earned supply. The raising of the bank rate is an implied threat to the domestic community that the central bank regards it necessary to set in motion forces which will lower internal prices so as to stimulate exports and make good the deficit in the international payment balance.

The result will probably be that numerous business men will pay off their bank loans through fear, while others will pay them off because charges have become more expensive. Thus the total volume of credit currency in the country will be contracted (see Chapter VI of Volume I), and a deflation of prices may thereupon begin owing (*a*) to the pressure of goods and securities for sale and (*b*) to the contraction of the total supply of bank credit currency.

In some cases, however, these forces may not operate quickly enough to please the central bank, and open-market operations will be resorted to; that is to say the central bank will sell its securities via the Stock Exchange to the public. Payment will be made by the member banks transferring to the central bank a portion of their so-called "reserves" held with the central bank. The reserve ratios of the member banks will thus be contracted; and they will be forced to call in loans from their customers. In this way a high bank rate is made "effective" by open-market operations and a downward movement in prices (and trade) is set in motion.

A high bank rate, it is true, may be effective without any further action on the part of the central bank; but sometimes further positive action is needed.

5. *The Rules of the Gold Standard Game.*

Looking at the system as a whole, the authentic gold standard depends for its successful operation:

1. On unimpeded gold movements;

2. On unimpeded dealing in the foreign exchange markets and on liberty to lend short abroad;
3. On a bilateral change in prices in *both* countries, *i.e.* on deflation in the debtor *and* on inflation in the creditor;
4. On the creditor country not imposing tariffs to prevent the resulting influx of goods.

Unless conditions 1, 3 and 4 are closely observed the authentic gold standard is bound to break down.

6. *The Preferences implied by the Gold Standard System.*

Comparing the gold standard system with paper, its implications are, as Dr. Gayer has pointed out,* as follows. The use of gold in the past has implied a double preference :—

I. First, a preference for such instability of prices as must be experienced under gold so as to avoid the possibly greater instability of prices which might result from a disappointing management of paper; and
II. Secondly, a preference for stability of exchanges as compared with a possible, though not necessarily certain, stability of the internal price level.

Certain other preferences were also implied: First, to make no attempt deliberately to control the aggregate amount of money within the country, but to put this control under the regulation of "foreign forces," and such "natural forces" as the cost of production of gold and new discoveries of the metal, each country's share of the world's total supply being left largely to its own economic strength compared with that of other nations. Indeed, one of the major merits of gold was felt to lie in its semi-automatic nature and the freedom which it enjoyed from political interference, even though it did involve placing the internal monetary system at the mercy of unpredictable and uncontrollable economic forces impinging from without. This was thought preferable to entrusting the management of such a tremendously potent

* See Dr. Gayer's *Monetary Policy and Economic Stabilisation*, A. and C. Black, Ltd., 6 Soho Square, W.1. 8*s*. 6*d*. A first-class work.

factor for social good or evil to the frailty of human nature. Non-human Nature was preferred.

Of course, even under the gold standard the internal paper notes and bank credit money of a country were " managed," but the management was dictated from without by external forces rather than from within by a definite political or economic policy. This was regarded as an advantage rather than a disadvantage, because the banking boom of the 1840's had shown how necessary it was to put some check—preferably automatic and not subject to political control—on the total quantity of paper notes and credit issued by bankers. Indeed the danger of gold being lost abroad as internal prices rose through bank credit expansion was itself admired as an effective check on over-expansion of internal bank credit.

The shortcomings of gold in so far as they were noticed at all were thought to be a price well worth paying for the freedom it ensured from imprudent banking and intervention and possible abuse by political authority.* Automatic limitation of the supply of money was thought to be a positive merit of the international gold system,† which, when added to the merit of exchange stability, was thought to make the case for gold unassailable.

Since the 1840's, however (to continue quoting Dr. Gayer), " the expansion of industrial efficiency and the use of steam and electric power have introduced the danger of the world's ability to produce goods outstripping the world's ability to produce gold or to economise the monetary uses of the metal; and competition between the nations for adequate supplies of the metal, and unwillingness to release it when a surplus supply had been obtained, have led to periods during which central banks in order to protect the convertibility of their paper have been forced to pursue a restrictive credit policy which prevented the expansion of industrial production from being as rapid as it might have been if internal money had not

* See Dr. Gayer's *Monetary Policy and Economic Stabilisation.*

† Since 1931, of course, attempts have been made in the opposite direction, namely, to organise the expansion of bank credit.

been tethered to an international gold system. Monetary policy was, in fact, perforce dictated not by domestic requirements but by the demand and supply conditions of foreign exchange."

"In reality the effect of the gold standard was such that although one country could pursue in isolation a deflationary policy to its heart's content regardless of currencies in the outside world; no country could pursue an expansive policy, unless other nations kept in step, without the loss of its monetary and banking reserves. Little progress in fact was possible for any one nation unless all other nations were marching forward simultaneously. There was, in fact, a powerful tendency for industry to be held in check by gold fetters. Progress was only possible in so far as refinements in gold economies by means of credit currency were invented, or in so far as gold production increased."

In the nineteenth century the possibility of a well-managed, as distinct from ill-managed, paper currency was not appreciated. The science of index-numbers was in its infancy; and the theory of money had been so inadequately developed that it was believed that no money could be anything but unstable and harmful unless it was well backed by, and convertible into, a precious metal.

The use of paper, moreover, was closely connected with the idea of dishonesty and debasement. If a king clipped his coins it was clearly debasement, and if the gold backing behind paper was reduced or removed it was also "clearly" debasement. Thus to remove the gold backing altogether was regarded as depriving money of all its value and wickedly levying a tax on all holders of money.

Gold, however, implies a preference for unstable prices, and unstable prices imply fluctuations in employment. It will therefore be the purpose of later chapters to analyse the theoretical objections to gold.*

* I have not described the Bill system whereby the supply and demand for foreign exchange is married *without* resort to the actual exchange market. This system has been sufficiently written up. See, for instance, Mr. Vallance's brilliant article in *What Everybody wants to Know about Money*. Gollancz. 5*s*.

CHAPTER VI

WHY THE GOLD STANDARD BREAKS DOWN IN PRACTICE. FUNCTIONAL DEFECTS

1. *Why Nations fail to work the Gold Standard properly.*

In the last chapter it was stated that the chief prerequisite conditions to the proper working of the gold standard were that:

1. Gold movements should not be impeded;
2. Gold-losing countries should deflate, while gold-receiving countries should inflate; and
3. Creditor countries should not put on tariffs to prevent cheap foreign goods flowing in the wake of the gold.

In the real world, however, no modern democracy seems willing to fulfil *any* of these three conditions prerequisite to the successful working of the authentic gold standard.

Actually, in fact, throughout the whole history of the world the Authentic gold standard has never yet been worked *properly*. Before the War a manipulated sterling loan standard was in operation. After the War, when a return to gold was made from 1925 onwards, England had lost her position as the world's chief creditor, and no other creditor country had become a world Central Banker, so that the manipulated loan standard was no longer operated. The world, in fact, was, for the first time in its history, required to work the *authentic*

gold standard according to the rules. The results, however, in practice were disastrous. Democratic nations found it economically and politically impossible to play the harsh authentic gold standard rules correctly. The rules they should have played in order to make the gold standard work successfully and the rules they did play were quite another matter. Each of the three major rules were, and are, broken as follows:

First, when gold begins to flow abroad from the debtor country the banking position is weakened. People then become frightened; and there may be runs on the banks. Credit deflation, moreover, brings about bad trade and causes unemployment and budget deficits.

In actual practice, therefore, to avoid all these things (which the gold standard positively requires) finance ministers often start prohibiting gold exports; combining their action with restrictions on imports either by tariffs or prohibitions. Their purpose, of course, is to check commodity importation and thus to prevent any further export of gold.

In some cases they even institute a control of the exchanges and positively refuse to supply importers of foreign goods with foreign currency unless sufficient has already been earned by exports. Indeed, the post-war method of working the gold standard has in practice been one not only of raising tariffs as a counter-stroke to any loss of gold, but also of rationing the exchange market, which means rationing imports, although the theoretical object of the gold standard is to facilitate international trade!

The second fault in the gold standard system, as worked in practice by modern administrations, is that the gold-receiving countries often hesitate to inflate credit (as they theoretically should do), (*a*) lest the internal price structure should become unreasonably upset, and (*b*) lest, if a rise in internal prices is allowed, it should give rise to so large a surplus of imports that more gold will eventually be lost than has just been received. In other words, gold-receiving countries often sterilise their gold,

and hoard it, and hesitate to inflate, although in theory they must inflate *if* the gold standard is to function properly.

Thirdly, even if gold-receiving countries do allow a modicum of inflation and goods do begin to flow in from abroad (because foreign prices are now relatively lower), there is always a political outcry for higher tariffs, which tend to be imposed to check unemployment.

Thus for political reasons finance ministers, afraid of the logical consequences, refuse in practice to work the gold standard according to its rules. The gold standard thus becomes a breeder of high tariff walls, although the main object of the gold standard, so its supporters declare, is to encourage and facilitate international trade.

The rigid gold standard, it is true, makes each *individual* transaction in foreign trade much easier and safer. Its ultimate effects, however, are to reduce its *total* volume, even though the main object of an international and rigid standard is positively to *augment* total volume.

2. *Post-war Confusion of the different Types of Gold Standard.*

Post-war politicians, and their advisers on the boards of the Central Banks, seem never to have realised that these practical difficulties would arise in working the gold standard according to the rules (which incidentally many of them did not seem to know either). They knew well enough that the gold standard, or rather one of the seven forms of the gold standard, worked fairly satisfactorily before the War. But they never seem to have analysed precisely *why* it worked so satisfactorily (*i.e.* because of England's peculiar position and methods); nor do they seem to have appreciated what conditions would have to be fulfilled, in the absence of a lending banking centre like London, if gold was ever to work satisfactorily again. All gold standards to them were the same.

The result was that after the harmful currency inflations of the early 1920's, the nations of the world deliberately returned to gold, in the hope and belief that since gold had

worked well in the past it would therefore automatically work satisfactorily in the future. They did not realise the difference between the "authentic" gold standard and the pre-war manipulated sterling loan standard.

3. *The Breakdown from* 1929 *onwards.*

Hopes, of course, were soon confounded. America, the new creditor, although she re-invested abroad freely up till 1927, soon became nervous of her ill-chosen investments, and her foreign lending rapidly dried up. When gold consequently began to flow in, instead of inflating credit and prices, as was theoretically necessary, she conservatively sterilised new gold on arrival and refused to superimpose thereupon a proportional credit currency, for fear of internal price-inflationary influences similar to those which had previously occurred in the early 1920's (when she was also on the gold standard and yet suffered a sharp price inflation). Her well-intentioned pursuit (considered *per se*) of internal price stability deprived international gold movements of their correct *bilateral* influence on internal commodity prices. The result was that to obtain any given export surplus to America, the debtor countries in Europe had to deflate twice as fast as would otherwise have been necessary *if* America had inflated properly. In other words, the gold standard was only worked unilaterally: deflation occurred in the debtor countries, but no inflation in the creditor. This deflation, of course, so hurt the domestic trade of the debtor countries that in order to check its continuance they put on import tariffs so as to reduce their foreign adverse balance of payments, thereby checking gold exports. America's (rather sensible) quest of internal price stability thus led to her *debtors* imposing high tariffs.

America, moreover, not content with the sensible sin of sterilisation, deliberately herself put on extra tariffs to check the influx of cheap foreign goods which began to stream in from the rapidly deflating European debtor countries. Her debtors therefore could not continue paying debts except in

the form of gold. International trade thus very largely broke down; meanwhile America captured the gold of the world.

Could anything have been more foolish? And yet, could anything have been more rational?

It was quite rational of America not to re-lend her surplus to foreign countries which already appeared to have borrowed too much; it was also rational of her to try to keep the internal value of her money stable; it was also, perhaps, rational of her to raise her tariffs in order to check unemployment. It also seemed (to her) quite reasonable to demand repayment of war debts. But America's actions—all of them highly rational *per se*—were incompatible with the proper working of the gold standard. She would not lend; she would not inflate; and she insisted on debts payments though she put on high tariffs. In other words, she broke three of the crucial rules on which the successful working of the gold standard depends. The result was that she captured the gold of the world and the gold standard inevitably broke down—not because war debts were themselves too big or because it is "theoretically" impossible to work the authentic gold standard properly—but because, for very good practical reasons, it was deemed not politic to do so.

Matters, incidentally, were made much worse because of the Wall Street boom, which attracted money (gold) from abroad not only for the purpose of speculation, but also for the purpose of earning the high short-term money rates which then prevailed and which reached 24 per cent. in August 1929.

The net result, then, of this "practical" working of the authentic gold standard was that although its main object was to minimise all impediments to international trade, in practice it actually led to the imposition of impediments. Debtor nations put on import tariffs so as to improve their trade balances and prevent their domestic trade from being ruined by the deflation which gold exports entailed; creditor nations also put on import tariffs to check the influx of cheap foreign goods which resulted from changed relative internal gold prices.

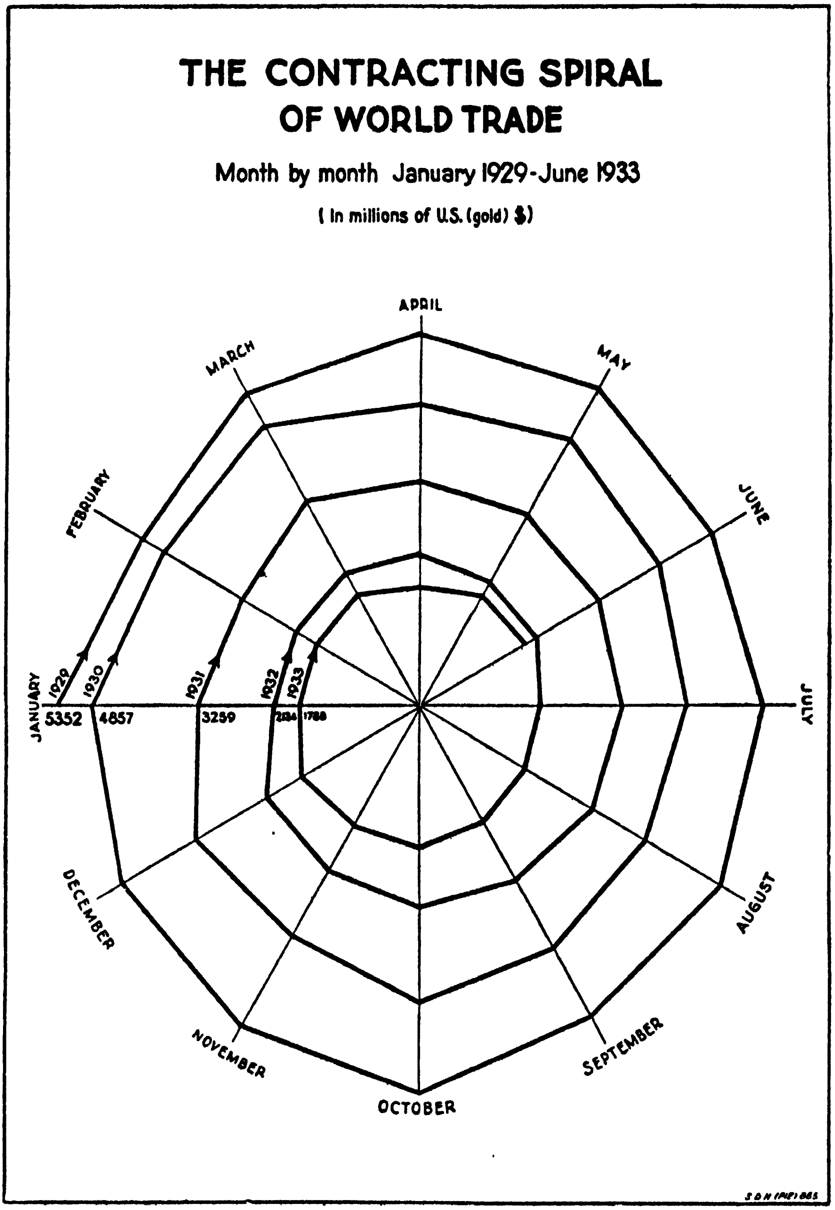
The gold standard was thus managed " in practice " in such a way as to lead to the growth of huge tariff walls, and thus to impede trade, thereby stultifying its primary object, namely, the facilitation and growth of foreign trade. Which, of course, is absurd—though a fact. See graph. World Trade fell by 66 per cent.

4. *Should Politicians or War Debts or the Gold Standard be blamed?*

One can, of course, blame the politicians and say that it was all their fault, and not the fault of the gold standard; but the fact is that the politicians found it economically and politically impossible to play the harsh authentic gold rules correctly. They felt obliged to take steps to avoid the Spartan consequences of these rules. They, and the bankers, were, in fact, forced to spend their energies in preventing the rules from being played, and in seeing that the normal results of adverse balances and gold movements were *not* allowed to eventuate. Even England offset her losses of gold by parallel internal credit expansions; and also temporarily made good her adverse payment balance by keeping her bank rate high so as to attract foreign funds. She was, in fact, balancing her international payment deficit by means of short-term foreign loans. When breaking point came in 1931, and the foreigners grew nervous, they withdrew their balances and the pound of course collapsed.

War debts, it is true, hastened on the collapse; and if it had not been for the war debts, the breakdown, I think, would have been considerably delayed. The war debts, however, by their size merely revealed more quickly the inherent practical difficulties of working the authentic gold standard, *i.e.* deflating if you are a debtor; and inflating, and submitting to an influx of cheap foreign goods, if you are a creditor.

To-day, 1935, for reasons which are too well known to require much explanation, most of the countries of the world (twenty-two of them) have again fallen off gold, and since they dislike fluctuating exchanges *per se*, they again declare themselves anxious to return to gold as soon as possible,—preferably



From the League of Nations Bulletin.

This chart might not unfairly be entitled "The Gold Standard (authentic) in Practice."

at devaluated rates so as to economise the world use of the metal.

5. *The Desire for a Reformed Gold Standard.*

Most persons, however, who advocate a return to gold are careful to stipulate that they reject the idea of going back either to the pre-war or to the post-war gold standards. They aim instead, and here I quote from one of the most powerful advocates of restabilisation, " at a reformed full gold standard, managed under central bank co-operation which shall simultaneously preserve the benefits of exchange stability between the various nations, and yet at the same time assuring them individually sufficient local autonomy in their domestic credit policies to pursue a course which would allow for the pace and direction of their own internal economic development, without saddling them with an uncomfortable international partnership such as has prevailed in recent years, imposing upon members of the gold group an external control."

According to Dr. Einzig, " there is nothing wrong with the gold standard, indeed if there were no such system it ought to be invented." On the other hand, he considers it " simply unthinkable that this country should ever return to the state of affairs when a small loss of gold necessitated a high bank rate and credit restrictions which victimised hundreds of thousands of wage-earners." *

All this no doubt sounds simple and easy, but is it not merely a galaxy of words? Are not those who demand a " reformed " gold standard, which shall provide exchange stability and yet not cause deflation and unemployment, asking for mutually incompatible amenities?

The point is this:—In the absence of an international banking centre, which is *also* a willing lender abroad, as was the case in pre-war England, the gold standard, if worked at all, must be worked according to the " authentic " rules. People therefore who talk about a reformed gold standard

* In *The Future of Gold*, p. vii.

which will provide the amenity of stable exchanges, stable prices, and not require any government "interference," are talking about something which cannot exist (unless there is only one universal banking system with one homogeneous bank credit currency (see Chapter I).

6. *Practical Reasons for continuing to stay off Gold.*

Actually, therefore, before the world returns to gold it ought to be demonstrated that instead of both creditors and debtors deliberately taking steps to avoid the economic consequences of playing the gold game correctly, they will in future willingly suffer the inconveniences of the gold standard for the sake of its conveniences.

Indeed, before the world returns to gold it must be proved that the nations will again work the gold standard "properly" in accordance—not with economic and political convenience—but with pure authentic theory.

Guarantees should be obtained:

1. That debtor countries will not impede the export of gold, nor put on tariffs to improve their trade balances and thus check the further exportation of gold.
2. That debtor countries will deflate *rapidly* on losing gold, despite it causing bad internal trade and probably upsetting their budgets and their banks.
3. That creditor countries will inflate their credit and prices rapidly, despite the damage it does to all internal creditor–debtor relationships, and despite the speculative boom that it will probably engender.
4. That creditor countries will passively put up with any unemployment caused by their creditor position, and will not put on tariffs to check the influx of cheap foreign goods which theoretically must flow in from foreign debtor countries in the wake of gold exported.
5. The only other alternative is to insist that creditor

countries shall re-invest abroad all their foreign surpluses, as England did before the War—despite their probably thinking at the time that investing in foreign countries which are already in debt is not particularly good policy!

Most thinkers on this subject, however, are beginning to agree that in practice *none* of these guarantees can possibly be given. And yet if these conditions are not adhered to, the fixed gold standard is bound to break down again in the future, and therefore seems hardly worth returning to.*

* I should perhaps also mention the Quota System. Mr. Vallance has described its astounding folly as follows : In their desire to correct the balance and at the same time to stimulate their export trades successive statesmen have "fallen into the crude error of supposing that the objective should be to equilibrate, so far as possible, trading balances between their own country and *each* separate country in trading relationship with it. That is to say, if country A found that it bought from country B, say, 100 units and sold to B only 50 units, it proceeded to ration imports from B down to 50 units. As a result, B's purchasing power abroad was proportionately reduced and it bought less from countries C and D, both of whom were previously good customers of country A but were now forced in turn to buy less of A's exports. Thus A's balance of payments would fail to improve and a further vicious circle of restriction would be ordained against C and D, in the form either of import quotas or more drastic rationing of licences to buy foreign exchange. As a result, the value of world trade had fallen in 1932 to only $2,000 million (U.S. currency), as compared with nearly $5,200 million in 1929."

CHAPTER VII

THE MECHANISM OF PAPER EXCHANGES

1. How the balance of payments is effected under paper.
2. How the payment of a monetary debt under paper leads to the exportation of goods.
3. Paper compared with gold.
4. How fortuitous international dealings upset the internal price economy under gold.
5. The effect on a country's exchange rates of a given purchase of foreign currency.

1. *How the Balance of Payments is Effected under Paper.*

As stated in Chapter I, the mechanism of Foreign Exchange must be such as to equate demand and supply in the foreign exchange market, and to bring exports and imports, visible and invisible, into precise equilibrium.

Under the paper exchanges this operation is simple and quick. If one country owes another more than it has earned as a result of its exports, visible and invisible, its bidding for foreign currencies in the foreign exchange market will, since demand exceeds supply, lead to a rise in their price. This will eventually stimulate exports from, and check imports into, the debtor country, and will thus, in the long run, redress the adverse trade balance and once more improve the exchange quotation.

Currency speculators, knowing this, are (unless violent internal currency inflation is expected) normally willing to buy a debtor country's currency when it first falls to a discount, and to hold it for the eventual recovery which can be expected as a result of the prospective change in the export/import ratio; foreign speculators thus, with their foreign money, make good any temporary deficit in exports. Later, when the improvement in exchange rates, which results from the increase in exports which the exchange depreciation itself engenders,

has occurred, the speculators reap a well-earned profit for the economic service which they have rendered to the community by running the risk of temporarily filling a gap between real imports and exports, *i.e.* between demand and supply within the foreign exchange market.

> *N.B.*—In the above remarks we have assumed that it is only *foreign* speculators who make good the (temporary) deficit between the demand for and supply of foreign money. Sometimes, however, English exchange dealers will take the risk; that is, they will borrow foreign money abroad, sell it to their customers at the dear rate for cash, hoping that when the rate itself has had time to influence the future export/import ratio, they will be able to buy the foreign money back cheaper and pay off their loans at a profit.

In both cases, however, it is speculators, either foreign or English, who make good the temporary deficits in the supply of foreign exchange until they are made good by actual trade.

2. *How the Payment of a Monetary Debt under Paper leads to the Exportation of Goods.*

Clearly, if a country is to pay its foreign debts it must export goods or services sooner or later. The actual exportation can, however, take place either before or after the paper-money payment. In other words, a country can pay its foreign debts either by exporting and selling goods *first* and then using the money-proceeds to pay the previously incurred debts; or, alternatively, it can first buy the foreign money with its own paper money and send the goods *afterwards* (*i.e.* antecedent buying of foreign money), paying such a price for the money that sooner or later goods will follow as a matter of course.

In connection with the above it must be noted that the limit of a country's capacity to pay reparations, or other international debts, cannot be assessed merely by measuring the

volume of its existing or recent exports. If its government can raise sufficient money internally, either by taxes or loans, to buy foreign money, the rise in the market price of the latter and the depreciation of the paper country's exchanges will set in motion a flow of goods (assuming that they are not stopped by tariffs) which will command for the debtor country sufficient of the money of the creditor country to repay large debts, even though a previous analysis of the debtor's export statistics would have made such payments appear impossible. An export surplus, in fact, can be positively engendered if a country will bid up the price of foreign money.

3. *Paper compared with Gold.*

The beauty of the paper system is that, as soon as any disequilibrium between demand and supply occurs, a sharp fluctuation in the price of foreign exchange *immediately* takes place, which, by its immediate action on both exports and imports, rapidly restores equilibrium. The laws of supply and demand and price are thus allowed to operate freely and quickly—as theoretically they should in any market, like that for foreign exchange, which is subjected to violent short-run fluctuations in both demand and supply.

Indeed, permanently to fix an exchange rate (*i.e.* the "price") in a market subject to sharp short-run and long-run variations in demand or supply, arising out of such varied and haphazard factors as short- and long-term loans, political debts, investments, flights of capital, surplus imports, and so on, is theoretically unsound, since it interferes with the natural and extremely necessary corrective of a movement in price to equate supply and demand. Paper exchanges do not have this fault; gold exchanges undoubtedly do. The result is that under the gold standard serious repercussions occur elsewhere, *e.g.* in home prices, which, in my opinion and in the opinion of many others, eventually do even more damage to trade than is done by fluctuating paper exchanges.

Some examples will make this clear.

4. *How fortuitous International Dealings upset the Internal Price Economy under Gold.*

For instance, if, under gold, Wall Street booms and the English Investment Trust Companies suddenly start buying American shares, £50 m. of gold may be quickly shipped from London to America, and the whole of England may be made to suffer a deflation.

Similarly, if a loan of £30 m. is successfully floated by some London issue house for internal use in, say, Australia, a similar deflation in England (and inflation in Australia) may occur.

Conversely, when Australia eventually pays back the debt, she herself must either undergo a ridiculous deflation (in order to bring about a relative price level that will force enough of her goods into England), or fall off gold altogether.

A most harmful rôle, moreover, is often played by the movement of short-term funds. These are estimated to total as much as £1,000 m. in Europe and America combined and big blocks are often hurried from one country to another, largely because of political fears. Under the paper system such movements are automatically checked soon after their inception, since the movement of even a small proportion of such funds causes the exchange value of the sought-after currency to appreciate so rapidly that further buying becomes too expensive, and the fears of keeping the funds where they are are offset by the greater losses which might be incurred by moving them. Under gold these movements have disastrous effects on internal trade and commodity prices.

Indeed, it is perfectly insane, on purely economic grounds, to allow fortuitous and non-essential occurrences of this nature to damage the internal monetary mechanism of a country and to upset its internal prosperity.

If people fully appreciated the dislocation entailed by the use of the gold standard (although it certainly pleases financiers) they would certainly not be so ready to demand stabilised gold exchanges.

The point is that the stabilisation of price in an unstable

market usually sets up more serious repercussions elsewhere. It certainly provides *some* people with an enjoyable amenity, namely, stable rates in an unstable market, but *others* are unfairly made to suffer. Paper has the obvious merit of (*a*) checking disturbing movements immediately, and (*b*) minimising their influence on domestic prosperity.

5. *The Effect on a Country's Exchange Rates of a given Purchase of Foreign Currency.*

The question naturally arises, To what extent does the purchase of a given quantity of foreign money depress the foreign exchanges of the buying country?

Unfortunately no exact answer can be given. On some days the purchase in London of only £100,000 worth of American dollars will shift the market by several cents (assuming England to be on paper); on other days, when dealings are more active and the market has ceased to be narrow, such a purchase, in excess of supply, may possibly not move the market at all—the surplus being taken up as it were by the buffer stocks of foreign money placed on the market by international bankers or exchange dealers.

In other words, at different times a given deficit in the balance of payments will move the market by a different percentage; no exact law of proportions can therefore be laid down.

* * *

The next question to arise is, How soon and to what extent will a given percentage movement in exchange rates or in net external prices begin to affect exports?

Here again no definite answer can be given. Indeed, instead of a decline in the exchange rate immediately stimulating exports, foreign buyers, in fear of a further fall, may possibly obey the Law of the Falling Market and hold off from the purchase of the now cheaper foreign goods for a while, lest a rival merchant should, by waiting, be able to undercut them later on. The greater the nervousness con-

cerning the future of exchange rates, the longer will probably be the delay before a given percentage decline in an exchange rate begins appreciably to stimulate exports. There will, it is true, always be a certain amount of arbitrage in the world's staple commodities, and they will be purchased in increasing quantities on any decline in exchange rates; but this natural tendency towards an increase in exports is often vitiated by dealers in the commodities and shares within the country with the depreciating exchange rate, marking up their selling prices over-night, *i.e. pari passu* with the movement in exchange rates; thus in reality no actual dealings or purchases take place, and no extra exports of staple commodities or international shares are engendered.

It is, in fact, impossible to dogmatise about the percentage movements which result from given percentage changes either in purchases of exchange or in "net external prices." One can only be sure of the direction of the movement—not of its magnitude; and even this is not always *immediately* possible.

CHAPTER VIII

THE THEORY OF PURCHASING POWER PARITY

1. *Factors determining Paper Exchange Rates.*

Although price fluctuations in the foreign exchange market for paper currencies automatically equate demand and supply within that market and bring exports and imports (visible and invisible) into the precise equilibrium required for effecting the international balance of payments, it is perhaps necessary to explain what factors actually determine the mean level of exchange rates, not only between the various paper currencies, but also between paper and gold currencies as well.

The rates of exchange between two paper currencies (and for that matter between paper currencies and gold currencies) are *primarily* determined by the relative internal price levels, *i.e.* by the relative internal purchasing powers of the two currencies. For instance, if a paper pound purchases in England 100 times as much, in terms of things in general, as a paper or gold franc purchases in France, the basic rate of exchange is 100 to 1, and Fcs. 100 is the purchasing power parity. Currencies, in fact, are relatively worth what they will relatively buy.

This is the theoretical parity; and in practice corrective forces are always operative which tend to bring about equilibrium somewhere near this level; for if the actual rate of exchange, at any one time, differs from the purchasing power parity, so that the franc, when changed into pounds at the current rate of exchange, buys, say, twice as much (or 20 per cent. more) in England than it buys in France, English exports to France will increase and French exports to England will decline. The French demand for pounds in the Paris foreign exchange market will then grow; the export-earned supply thereof on offer in Paris will decrease, and the pound will rise in terms of francs and approach the true purchasing power parity.

If an overswing in the exchange rate occurs (as often happens), corrective forces will then work in the opposite direction. The tendency, however, is always for rates to fluctuate about their true purchasing power parities.

2. *The Existence of Purchasing Power Parity does not guarantee the Automatic Equation of Exports and Imports.*

The purchasing power parity theory is, however, only valuable as a *basis* for calculations. Its general principles certainly cannot be disregarded, but all manner of minor factors may operate to cause an exchange rate to diverge some 10 per cent. or more from the true purchasing power parity. And what we are now about to write is as true for gold exchanges as for paper.

It is, I know, often asserted that the gold standard keeps prices the same the whole world over. But this is not so. Wide divergences from true equality of purchasing power often occur.

The reason is this. Even if the gold prices of separate countries under the gold standard *were* exactly equal and at purchasing power parity, as measured by index-numbers, there is nothing to guarantee that country A will buy from B (or the rest of the world), either directly or triangularly, exactly as much as B buys from A (or from the rest of the world). Differences

in either tastes or requirements might lead to an appreciable degree of disequilibrium.

In such a case the resultant over-importation by one country would, as a result of gold exports, depress its own price level and raise that of the other country, so that the two internal gold price levels, as measured by indices, would no longer be at purchasing power parity.

But there are other causes of divergence from purchasing power parity both under gold and under paper. Let us consider the case of paper first.

3. *Causes of Divergence from true Purchasing Power Parity.*

If England has an all-round export tariff of 10 per cent., *or* if France has an all-round import tariff of 10 per cent., the net external prices of English goods to Frenchmen will be increased by 10 per cent. and the pound should theoretically be some 10 per cent. cheaper in terms of francs than would be suggested by any index-numbers which accurately measured true purchasing power parity.

Similarly, if England has an adverse balance of old political (or commercial) debts due to France, the annual extra bidding for francs in the London exchange market, which these debts will involve, will keep the price of francs somewhat above true purchasing power parity, thus stimulating English exports (and checking imports into England) and so tending to earn, by means of *surplus* commodity-and-service exports over commodity-and-service imports, the extra francs needed to liquidate the political debt.

Another temporary cause of deviations from the true purchasing power parity is international movements of capital due to fear or lending. For instance, if inflation is expected in England, people may remove money balances from London, and numerous pounds may be exchanged for francs. The extra supply of pounds and demand for francs thus engendered may temporarily depress the rate well below the true purchasing power parity.

Loans made by England to France, or short-run investments of English floating balances in the French money market, will have a similar effect.

A boom on the Bourse might also cause a considerable long-term flow of funds from London to Paris.

4. *Deviations caused by Triangular Trade and Triangular Arbitrage.*

Another cause of divergence as between two paper currencies is triangular exchange operations. Much actual trade is triangular: for instance, England buys cotton from America; America buys rubber from Malaya; and Malaya buys manufactures from England (paying for them triangularly with rubber). All these commodity transactions give rise to foreign exchange transactions; and it is an axiom of the foreign exchange market in any country that the direct and "triangular" prices of a foreign money cannot diverge far for long; for, if there is a divergence, exchange arbitrageurs will buy the currency via the cheapest route and sell it via the dearest, with the result that "triangular" and direct rates are soon brought into equilibrium.

The net result of these triangular operations may be that the rate between two paper exchanges is made to diverge from the true purchasing power parity.

In this way one country's exchange rate may become undervalued in relation to another's, thus stimulating exports from the first to the second; while the second country's rate may be undervalued in relation to that of a third, so that exports are stimulated from the second to the third. The first country may triangularly pay for its surplus imports from the third by surplus exports via the second, and thus adjust its total international payment balance triangularly or quadrilaterally.

There is, in fact, no reason to expect the rate of exchange between every pair of countries to be at the true purchasing power parity. Indeed a country's list of exchange rates should be looked at as a whole rather than pair by pair. The whole

series of its separate exchange quotations are, in fact, what is relied on to produce equilibrium in the balance of payments, either directly or triangularly.*

5. *Disparities in Relative National Price Levels under Gold.*

Having discussed deviations away from purchasing power parity under paper, we must now discuss them under gold.

As shown in Chapter V, if, as between any pair of gold-using nations, prices are too high in, say, A as compared with B, so that A's exports fall and its imports rise, gold flows from A into B (possibly triangularly) so as to settle the adverse foreign balance. This should theoretically lower prices in A and simultaneously raise them in B, so that an upward movement in B's prices meets (about) half-way the downward movement in A's, stimulating exports and checking imports, and thus correcting the trade balance.

But it by no means follows that just because countries are on gold, prices in the different countries will be equal, *i.e.* at purchasing power parity.

For instance, if on-gold England has to pay on-gold America so many million pounds a year in respect of past political or commercial debts, an exactly equal gold price level in the two countries will *not* effectuate the equation of the payment balance; nor, assuming that the gold exchange rate is fixed, will it enable England to earn that necessary surplus of dollar exports to America required to meet the desired debt payment, even if, in the absence of such debts, an equal gold price level (coupled with a fixed exchange rate) would have automatically caused commodity-and-service exports and imports to balance.

The tendency will therefore be for a deficit to mature in the balance of payments, although there is no deficit in commodity-exports in relation to commodity-imports. The excess

* Thus stabilisation conferences wishing to assess rates correctly should look, not so much at countries pair by pair, as at all countries in relation to each other, *i.e.* they should theoretically examine the whole triangular network—a rather hopeless and impossible task!

demand for American money (arising, if you like, out of the import of debt cancellations) will cause gold to be sent to settle the difference and/or prices to rise in America and to fall in England to an extent sufficient to earn for England annually that surplus of dollars which is required to meet the special debt payment.

Thus creditor countries, *which are in process of being paid off* by debtor countries, tend, under the gold standard, to have *higher* internal price levels and costs of living than their debtor countries.

* * *

On the other hand, if a creditor country is still in process of *lending* to other debtor countries (more than it is receiving) the tendency, under the gold standard, will be in the opposite direction; for any increased monetary loans made by A to B will, if not spent locally in A, lead to an export of gold from A to B, and a rise in B's prices and a fall in those of A—which will tilt the internal price level in the opposite direction, so that the creditor's internal gold price level will tend to be lower (not higher!) than those of its debtor.

Eventually, however, when the debtor country begins to pay off its past loans, its internal prices, instead of being higher than that of the lending country, will be forced down to a lower level.

* * *

This theory also holds good for other international payments under the gold standard, such as movements of short-term funds owing to fear, or in order to earn a higher rate of interest, or to take part in a speculative Stock Exchange movement, etc.

* * *

To think, then, that the gold prices of manufactures (as distinct from arbitraged raw material prices) must be the same in all on-gold countries, is entirely untrue and fallacious, although it seems to have been the belief of most of the members of the Macmillan Committee.

6. *The Triangular Trade of one Country as an influence on the domestic Price Level of another.*

Triangular influences may also be considerable.

Suppose, for instance, that on-gold England has in the past imported heavily from on-gold America, or that England owes America a large political debt. Under such circumstances on-gold England must earn with her exports, either directly or triangularly, a large surplus of American dollars.

Her exports of gold will depress sterling prices, not only in relation to dollar prices, but also in relation to francs, pesetas and other on-gold currencies. This will stimulate English exports all round; for the English exchange market will be buying dollars, not only directly, but also triangularly via Paris and Madrid, etc.

And the second transaction of each of these triangular purchases will cause gold to flow from Paris and Madrid to New York, just as the first transaction caused gold to flow from London to Paris and Madrid. America, however, will be getting gold from *all* directions, whereas Paris and Madrid are both receiving it *and* parting with it. The tendency will therefore be for on-gold American commodity prices to be higher than on-gold commodity prices in France and Spain. The triangular influence will have caused the price disparity.

This factor may not be of great importance, but it is too big to be neglected entirely.

7. *Stabilisation Conferences.*

If the foregoing constitutes the correct theory of the foreign exchanges, how are statesmen to make use of it so as to order their nation's economics to the best possible advantage?

Take, for instance, the Continental gold bloc to-day: since they are still on gold, it is often thought that the relative internal prices of these countries are in equilibrium and that if the group as a whole devalued by, say, 20 per cent. so as to get into line with sterling, or say 35 per cent. so as to get into line with the

American dollar, all would be well in future. Professor Gustav Cassel, however, writing in the Quarterly Report of the Scandinavian Bank in January 1935, estimates that the relative over-valuation of the currencies of these countries in relation to the pound sterling in September 1934 was as follows:

Belgium	+ 7%
Italy	+ 13%
France	+ 17%
Holland	+ 22%
Switzerland	+ 41%
Germany	+ 57%

In so far as this estimate is correct, there may perhaps have to be considerable readjustment of existing rates of exchange as between the various countries in the gold bloc.

At this point, however, a statistical warning is necessary. It is customary among economists, when trying to measure over- and under-valuation, to seize upon some year like 1913 or 1930 when most countries were on gold: to reduce the price indices of the two countries in this year to 100, and then to measure comparative percentage changes in the two internal price indices. Perhaps a difference of 15 per cent. results. The investigator is then inclined to state that the present equilibrium rate diverges 15 per cent. from 1913 (or 1930) and that when revaluation and restabilisation on gold take place, country A's rate must be 15 per cent. lower than B's if equilibrium is to be secured.

But this argument, although better than nothing, is dangerous. All manner of changes in the relative intensity of international wants for each other's different goods, coupled with deviations arising out of new tariffs, or out of undischarged loan and debt payments, may require, as an equilibrium rate, an actual rate some 10 per cent. different from the base year of 1913 or 1930, merely so as to engender that surplus of exports which the interim changes in tastes, tariffs, debts, loans, etc. now have made necessary.

Actually the correct rate required to secure an effective export–import equilibrium *cannot* be measured statistically, since it depends on the international elasticity or inelasticity of demand for different products at different net external prices. The equilibrium rate can, in fact, only be found by a market process of trial and error; and Stabilisation Conferences, no matter how well intentioned, will not be able to decide what are the correct new relative rates required so as to attain equilibrium. All "calculations" will have to be mere guesses!

Moreover, even if the right rate is accidentally hit upon at the outset, it may become the wrong rate in the course of a few years; *i.e.* as soon as either international demand schedules for goods changed, or as old debts were paid off, new debts incurred, or new investments made.

There is, in fact, no permanently correct equilibrium rate between two currencies, even if their internal prices remain stable. And when the originally correct rate gets out of line later on, internal prices will have to be inflated or deflated to maintain equilibrium *if* the exchange itself is to remain fixed.

* * *

Imagine, for instance, Belgium, Switzerland and France all devaluing their gold currencies simultaneously by 40 per cent. According to Cassel's figures (*i.e.* plus 7 per cent. for Belgium and plus 41 per cent. for Switzerland) the Brussels rate would then be 34 points undervalued in relation to Zurich. The result might be that all the central European capitalists who had sent their funds to Switzerland over the past twenty years would suddenly remove them to Brussels, and Switzerland, despite her recent devaluation, might be driven off the gold standard at once, directly because of withdrawals of old capital and indirectly because of the comparative safety of undervalued Belgium as a centre. It is even possible, if and when strong revival occurs in Germany and Austria, that fugitive capital deposited in Switzerland may return to these now depressed countries, and that their industrial revival may force little Switzerland off gold.

Theoretically, it is the duty of an international Stabilisation Conference to take account of all these factors for the future and to assess the right rate for, say, Switzerland accordingly. But the "right rate" would only be "temporarily" right. The difficulties facing such a Conference are insuperable!

Indeed, it is just as sane to try to peg the price of oil in perpetuity as to try to peg the price of the Swiss franc.

And yet there are people who glibly talk about calling a new conference to select new gold parities for the various nations, so that international trade may once more revive. As soon as one begins to study the problem, one sees the apparent futility of attempting such a programme.

The reason why the pursuit of the goal is so futile is that it involves trying to fix a permanent price in a fluctuating market, where demand and supply are always changing, and exhibiting not only a temporary or seasonal trend, but probably a secular trend as well—owing to tariffs, or to old debts, or to new investment, or to changes occurring in national needs and also in national industrial development. Only the very jejune can believe in Stabilisation Conferences being permanently successful.

Statesmen, however, who may be determined, *despite* the arguments which we have advanced, to repeg their exchanges on gold must try to guess what margin ought to be allowed in respect of differences in international efficiency, outstanding debt payments, probable needs for loans from abroad in the future, etc., etc. This is not an easy task. But the onus of decision cannot be avoided by nations which (foolishly) wish to restabilise on a permanent basis.

8. *Digression on the lack of accurate Index-Numbers.*

Although in the foregoing remarks we have blithely referred to index-numbers as being the means of measuring purchasing power parities, we must hasten to add that most of the indices in popular use are not by any means a reliable measure of those internal prices and costs which primarily influence

foreign trade and foreign exchange rates. For instance, some countries, like Chile, produce and export only one or two things, *e.g.* nitrate and copper; they import most of the other manufactures and the raw materials which they use. The prices of these latter, therefore, naturally depend, in the main, on the prices prevailing for them abroad, multiplied by current exchange rates. In other words, the prices of many of the items composing any popular Chilean index-number will be themselves determined mainly by the Chilean exchange rates, and will therefore *not* be a suitable yard-stick with which to measure what the correct Chilean exchange rate ought to be, and what disparity, if any, exists.

In the case of such countries as Chile, I admit, a method based on the measurement of comparative prices is useless; for if the goods produced by two different countries are *not* the same it is obvious that one cannot accurately measure the equilibrium rates of their currencies merely by using general price indices. It will merely be a *calculatio per se*, which will always suggest that the current rate is the equilibrium one.

If there existed such a thing as an index of the price of "labour efficiency" for each country one might perhaps use it to compare the relative purchasing powers of two currencies, but this imaginary conception does not in practice exist. The result is that the purchasing parity method is only useful for assessing deviation in the case of countries producing many similar commodities.

This brings us back to the basic fact about exchange rates, namely, that what finally determines exchange rates is the buying and selling of foreign money, and it is only in so far as comparative differences in internal prices and costs lead to buying and selling of foreign goods, and therefore of foreign money, that the purchasing power parity theory is of any practical use.

Popular Chilean index-numbers will not, it is true, be a suitable means of measuring any tendency towards disequi-

librium in exchange rates; but this does not for one moment vitiate the general truth of the argument that currencies are, in terms of each other, approximately worth what they will relatively buy, although in certain cases, for instance that of Chile, the real things to compare are not so much the prices of manufactured commodities and raw materials (*i.e.* imports) as the local prices of given "units of labour-efficiency," such as are used up in all types of production.

The paper exchange rates will, however (unless controlled), in any case be such as to bring imports and exports into equilibrium; and if one country or the other happens to import too much, or borrow or lend too much, the exchange rate will move so as eventually to correct the disequilibrium. This is as true of countries like Chile as of any others, *e.g.* China or France.

9. *Summary.*

In short, we find that the correct figure for an exchange rate between two currencies is above all one which will equate all types of supply and demand in the foreign exchange market. But since it is, *in the main*, the comparative internal costs and prices of actual *commodities* (rather than services) which give rise to imports and exports, and thus to the major part of demand and supply in the foreign exchange market, the rate must necessarily approximate, in the case of countries with any wide diversification of industry, to purchasing power parity as measured by general commodity indices.

Short-run capital movements and annual debt payments can certainly cause sharp short-run and long-run deviations away from the true purchasing power parity; while tariffs may also keep exchange rates permanently on one side or other of the true parity. Relative internal purchasing power is, however, the dominant influence, and this is true no matter whether the currencies are paper, gold, silver, or anything else. If the "miscellaneous" factors such as tariffs and political debts to which we referred in the previous section do

not alter, changing internal prices for commodities and services will alter exchange rates, roughly in an equal degree—although, of course, speculative anticipations and fears may not only magnify each movement but may cause it to occur in advance of actualities. Fears and sudden mark-ups or mark-downs in prices—as well as tariffs, debts, loans, trade balances, etc.—may push an exchange rate away from true purchasing power parity and make it either over- or under-valued statistically.

In the short run, it is the balance of trade and of payments which determine the current exchange rates, but it is relative internal prices and costs which in the long run determine the balance of trade and payments.

The purchasing power parity theory is a useful " fundamental " conception. It is, however, only partially true.

10. *The Damage done by wrongly pegged Rates.*

In respect of the problem of restabilisation the following points are worth noting.

In the real world the comparative prices of commodities in different countries do not vary (unless the commodities deteriorate in transit) by much more than the costs of transport and tariffs, for profit-seeking traders tend to arbitrage out any differences in prices by a process of demand and supply. Trade, in fact, usually takes place only in commodities whose costs (rather than their arbitraged market prices) are different in different countries, as measured by current exchange rates (gold or paper).

A point to notice in regard to the foreign exchanges is that the level of exchange rates under paper, and of internal prices under gold, tends to become one which reduces the *number* of goods internationally traded in, to a minimum, and which equalises the net external prices of as many as possible of the goods which are produced in *both* countries, so that there is no profit either in exporting or importing them. Indeed, such an exchange rate is what many economists mean by the expression "the equilibrium rate" or purchasing power parity.

When an exchange rate is at purchasing power parity, international trade, although it only takes place in those few commodities in which there is still a commercial profit available from transfer, is at its *maximum*.

This is a principle of the foreign exchanges and of foreign trade which is of the utmost importance to statesmen; for it implies that when rates are either undervalued or overvalued, international trade will decline in volume from the optimum; and that therefore what statesmen should really strive for is not under-valuation but perfect equilibrium.

On a superficial view, it appears that under-valuation is the objective to aim at, since it stimulates exports and shuts out imports. But this checks trade in one direction as much as it stimulates it in the other; and since other countries are damaged by one's own undervalued rates, they naturally tend to put on tariffs and restrictions. Hence, although at the commencement one's own imports may decline and exports expand, eventually there will be a check to exports. This will occur not only because of retaliatory tariffs, but also because under-valuation (if it lasts long) will, under a paper system, give rise to a fresh disequilibrium in the opposite direction and the country will eventually find itself not only with an overvalued currency but *also* with a series of adverse foreign tariffs.

Moreover, the manufacturers in the country with the undervalued currency, seeing imports checked by under-valuation, may set up much new plant to exploit the exchange-protected home market; but as soon as this has been done, the under-valuation may disappear and the country may again be flooded with imports. The new plant may thus be wasted, because its erection was not in accordance with the principles of international division of labour or the Law of Comparative Cost. Thus the weapon of under-valuation, although apparently so attractive, may recoil upon the heads of those who use it.

The best rate for a country is the true equilibrium rate

(as found by trial and error in the market itself) and not one either of artificial under- or over-valuation.

Quick market fluctuations about this true equilibrium rate do *not* encourage the erection of uneconomic plant and machinery or the setting up of tariffs. Artificial long-term deviations, however, both under gold and under paper, encourage (*a*) the erection of uneconomic plant in the undervalued country, and (*b*) the building of tariff walls by the overvalued country.

The paper exchanges, if not controlled, will, I admit, fluctuate *astride* the equilibrium rate, becoming first under-valued and then overvalued; but the deviations in either direction will never last long, so that countries will *not* be encouraged to set up either uneconomic plant or uneconomic tariffs.

Trade, I repeat, will be at its *maximum* if rates are in equilibrium, although the number of commodities traded in will be at the *minimum*. And these commodities will be those in which *both* countries reap a net benefit from the specialised international division of labour.*

Certainly for countries with a paper standard suddenly reverting to the gold standard, mild under-valuation is a condition to strive for, since, under a *gold* system, under-valuation minimises the risks of banking reserves suddenly being exported, and thus setting in motion a disastrous internal credit deflation. But considered *per se*, under-valuation is unsound from the long run point of view of domestic and world economy. The fact that it is something to strive for under gold is not a point in its favour, but rather an objection to the gold system.

* In the main, of course, it is differences in geological or climatic conditions, and in racial efficiency in production, that determine which commodities shall be exchanged.

CHAPTER IX

PEGGING OF PAPER EXCHANGES

1. *Equalisation Funds.*

Although a paper exchange rate when left to itself tends to fluctuate more or less *astride* purchasing power parity, nevertheless, a country can, for lengthy periods on end, peg its exchanges, even under a paper system, at almost any level (up to, say, a 30 per cent. bias) it likes.

If a paper-using country wants to keep its paper exchanges (or gold exchanges for that matter) fixed and is willing to institute a rigorous enough control over the actions of its own international traders and over its foreign exchange market, it can, by refusing to grant import licences unless enough foreign currency has already been earned by exports to pay for future imports, adjust the demand for foreign currency to the available supply, and thus keep its exchange rate virtually fixed (as was being done in Germany in 1934).

Similarly, if it builds up a large enough *internal* Equalisation Fund, with which to buy foreign currencies and keep its exchange *down*, if necessary, or conversely, if it is able to borrow abroad a large *foreign* fund so as to be able to keep its exchange *up* (by selling the foreign currency it has borrowed), it will in theory be able to counteract the natural inequalities in demand and supply such as mature on commercial and financial account in the *uncontrolled* foreign trading and investment market; it will thus, until one or other fund has at last given out, be able to peg its exchange rates where it wants to.

If, however, this system of artificial pegging happens to be instituted at the wrong price, an excess of either imports or exports, visible or invisible, will soon occur and continue, and will eventually use up one fund or the other. Thus, in the long run it will prove a disadvantage and a waste of money to have bolstered up an uneconomic position. It will merely have been giving a governmental or taxpayers' bounty to certain groups of either foreign or domestic consumers and/or traders.

Artificial pegging of an exchange rate is therefore extremely risky, unless developments occur which will later inevitably make the initially wrong rate eventually the right one. Trying to peg the paper exchange is normally unsound political economy.

2. *Control of Imports and rationed Exchange Markets.*

The other method of pegging a paper exchange is to ration the exchange market and deliberately to control imports from abroad, and capital movements. This is likewise risky and unsound, for it tends to lead to retaliatory tariffs abroad, so that eventually exports as well as imports will probably be checked. In fact, all artificial regulation of foreign trade and exchange rates is in the long run uneconomic and is therefore to be deprecated—even though, in the short run, such a policy may appear to have much in its favour.

CHAPTER X

THE FORWARD EXCHANGES AS A PALLIATIVE TO THE UNCERTAINTY CAUSED BY PAPER

1. The Forward Exchange mechanism.
2. The diminutive cost.
3. Occasional difficulties.
4. Long-term contracts.

1. *The Forward Exchange Mechanism.*

Certainly the use of paper money presupposes fluctuating exchanges, which *per se* are a disadvantage; but since controlled paper is better than gold for internal trade (as we show in Volume I), and in the long run for external trade also, and since a forward exchange market can be instituted to shift the burden of exchange risks from commodity traders to voluntary speculators, paper currency can be made to work satisfactorily in foreign as well as domestic trade.

The question of forward exchange is sufficiently important to receive some brief description.

International traders selling goods abroad for foreign money due, say, on three months' credit, are enabled by means of the forward exchange market to sell the currency, eventually due to them three months hence, at about the spot rate, thus eliminating their own exchange risk.

The exchange banks who buy this forward foreign currency from them (at the spot rate plus their "forward" commission) * can also eliminate their own exchange risk by borrowing an equal amount of foreign currency in the foreign banking centre and then transferring it at once into pounds at the spot rate. There will, it is true, be a few hours' delay, during which the

* There is sometimes a discount.

rate may move, but this " risk " is charged for in the quoted " forward " rate.

The net result of the transaction is that the trader has shifted his own private exchange risk to the banker, who has in his turn eliminated his own exchange risk by borrowing abroad an amount (equivalent to whatever will be coming to him abroad from the trader three months hence) and transferring it into sterling *at once*, mentally ear-marking, of course, what he is eventually due to receive abroad as the fund with which he will pay off his foreign loan.

In other words, the forward selling of a foreign currency by a trader merely requires an equivalent short-term loan (in foreign money) from a foreign banker abroad. The proceeds are then used for an *immediate* purchase of sterling with the foreign money which *might* otherwise have been postponed for three months. The spot rate is thus made to move *to-day* instead of perhaps three months later.

In such cases if demand in the spot market happens to exceed the available export-earned supply, exchange speculators are relied on to put up the balance, in response to the cheap spot rate, in accordance with the procedure explained in Chapter VII.

2. *The Diminutive Cost.*

In the actual forward exchange market, however, a great many industrial " forward " deals, both purchases or sales, will almost certainly cancel out. For instance, if in addition to there being Englishmen selling goods on three months' credit (say to Holland), there are also Dutchmen selling goods on three months' credit to Englishmen, demand and supply in the forward exchange market may largely cancel out, in which case the forward deals can be married at a diminutive cost just sufficient to compensate the market for its work.

More often than not, however, there is an excess, one way or the other, in the *forward* market. For instance, if Englishmen (and others) want to sell more guilders forward than are

offered (on account of their having sold to Holland more goods than they have bought), the exchange banks can, after marrying such forward amounts as will balance out, merely borrow in Amsterdam the residual amount which happens to be the excess quantum. Thus their own expenses, apart from telegrams, etc., will merely be the Amsterdam rate of interest on this unmarried balance—a charge which, however, can be spread over *all* the forward deals which they have effected for traders. Forward rates should therefore never differ very widely from spot rates, being mainly determined by the foreign rate of interest, on the *unmarried* balance only. The cost to traders, therefore, should be extremely small.

Even if the traffic is entirely one way, foreign interest rates should be virtually the only appreciable expense.

3. *Occasional Difficulties.*

It must be admitted that, in practice, forward rates of exchange have often differed from spot rates by much more than the current foreign rate of interest. This, however, has usually been due to foreign governments discouraging bankers from facilitating private bear speculation (in, say, the guilder), by making loans difficult for foreigners to come by; such restrictions admittedly tend to make forward dealings difficult. High charges are therefore often made or actual restrictions on forward dealings imposed. Foreign (and English) bankers, moreover, usually charge as much as they can, because extravagant charges increase their own profits! In theory, however, a forward exchange rate should not diverge from the spot rate by much more than the foreign rate of interest; and competition would tend, unless governments interfered, to reduce forward charges to reasonable proportions.

* * *

The above paragraphs do not, of course, give a complete picture of the forward exchange market, but may suffice to show the enemies of paper currency how, for a very small

interest cost, paper exchange risks can be shifted by traders away from themselves, with the aid of their bankers and the loan market abroad.*

It is true that, as regards the "spot" market, if, say, the Dutch demand for sterling exceeds the Dutch export-earned supply, the deficit has to be (temporarily) made good by currency speculators, but such speculators, at a price, are *always* forthcoming unless exchange transactions are controlled or rationed by governments. Indeed, it is only if countries are inflating or are expected to inflate excessively fast, that speculative buying ever dries up. That, in fact, is why in the early 1920's it was difficult to organise sound forward exchange markets, and why the experiences of these post-war years do *not* indicate what can be done if the countries of the world go on to controlled, as distinct from uncontrolled, paper. If a paper currency is not being inflated wildly a forward exchange can easily be built up, even for somewhat backward countries.

A forward exchange market does not, of course, eliminate paper exchange fluctuations, but it does enable *bona fide* traders to shift the risk on to speculators, and the cost, as a general rule, should be merely a diminutive matter of small interest charges.

4. *Long-term Contracts.*

If international traders are committed to long contracts, say for a three-year constructional programme, they should, of course, renew their forward sales of currency every three months, and the cost thereof would have to be included in estimates and be considered as a normal *extra* cost in their business. Troublesome, it is true; but soon got used to, and the more widely the forward market was patronised the cheaper would become the cost.

* Ignorance of these factors is astounding. A few days ago I heard of an Englishman with a huge wine-importing business from France who, although complaining of exchange fluctuations, was not aware that he could buy francs forward, although he had been in the trade for twenty-five years.

Even a long-term exchange risk can be avoided if the foreign municipality (say), ordering a tramway system from English contractors, will borrow *all* the necessary money at once and transfer it at once to England, placing it on loan in England until payments to the English contractors fall due. Here again the extra cost should only be equal to the difference in current national interest rates.

It is only in backward countries where the bankers are unable to lend to foreign bankers, or in currencies in which no one is willing to speculate, that a forward exchange market cannot easily be built up. And since these countries are few and small, the disadvantage is insignificant.

It is true that certain merchants might, from time to time, hold back from foreign trade transactions lest an early fluctuation in the spot rate—despite their being able to cover forward—might enable some other competing trader to operate on more favourable terms; and hesitation of this nature is certainly one of the undeniable disadvantages of controlled paper.

But the benefit of a stable internal price level to a country as a whole seems more than sufficient to compensate for the inconvenience, uncertainty and extra small cost imposed upon a small minority of foreign traders. Moreover, as already stated, although gold makes individual foreign trade transactions less worrying, it tends, in the end (because of the tariffs and depressions to which it leads), to reduce its aggregate magnitude. Paper, on the other hand, although making individual transactions more troublesome, tends in the end to make them more numerous.

International financiers, whose business it is to raise long-term foreign loans for the development of overseas countries, do not like fluctuating exchanges, but anyone lending to a foreign enterprise should realise that he is not only taking a risk on the enterprise itself, but also on the ability of the foreign country as a whole to earn an export surplus with which interest and redemption payments can be made. If he distrusts the

country, although trusting the enterprise, he should refuse to make the foreign loan. (And this applies as much to gold as to paper.)

Probably the best solution is for loans to be made in terms of the money of the lending country. For, if the currency of the borrowing country subsequently declines, its export surplus will probably be stimulated; while, should any rise in internal prices take place in the borrowing country, the revenue of the business or municipality to which the loan has been made may quite possibly increase internally so that more money will be available wherewith to buy the now more expensive foreign currency needed for debt service.

If the enterprise is not strong enough, and if the country is not strong enough, to fulfil these conditions, the foreign loan is probably not justified, and would be much better refused by the lending country.

Too many instances have occurred recently of foreign loans being floated by New Issue Houses when long-term economic conditions did not justify them. But more will be said on this matter in Volume III when we discuss the benefit to a country of its foreign investment.

CHAPTER XI

PRACTICAL DIFFICULTIES OF RETURNING TO GOLD

1. The difficulty of gold redistribution.
2. The need for guarantees—which cannot be given.
3. The American difficulty.
4. The risks of being the first country to act.
5. Failure to agree concerning new rates.
6. Summary.

EVEN if it were considered economically and politically desirable, there are practical difficulties in returning to gold. The chief of these difficulties are as follows:

1. *The Difficulty of Gold Redistribution.*

Practically all the gold in the world has got into the hands of only a few countries (see diagram on p. xi) and there exists no method of redistributing it amongst the gold-lacking nations, except:

(*a*) By loans, which the gold-holding countries would probably be unwilling to grant (since the off-gold countries would probably not need the gold unless they had an external trading deficit; and then the service of the loans would be doubtful), or:

(*b*) By the gold-lacking nations going back to gold at such undervalued rates, as compared with the other on-gold countries, that they were enabled to contract a huge export surplus, which would eventually earn for them gold from abroad and lead to its importation, as happened in France in the 1926–28 period, when she fixed her currency at an undervalued rate.

This, however, would certainly not meet with the approval of the present gold-holding nations, for it would mean that their trade was undercut internationally, and they would probably be inclined to put on tariffs, not so much to check the loss of gold as to prevent the influx of cheap foreign goods. Such tariffs would, however, prevent the gold-lacking countries from getting any gold.

In view of these practical difficulties the gold-lacking countries are not likely to be able to go back to gold at all unless they adopt an internal reflationary policy, and in doing so either print paper money or borrow from their banks, and then with the proceeds buy foreign currency and gold; so that later, when internal prices have had their inflationary rise, they may be in a position to go back to gold at new devaluated, and probably somewhat undervalued, rates.

A much more likely procedure, however, is that the present gold-lacking countries will either adopt the Gold-Exchange standard on the pre-war Indian system, or, more probably still, remain off gold altogether, and allow their exchanges to fluctuate in accordance with the laws of supply and demand.

N.B.—Under a so-called "Gold-Exchange" standard the gold-lacking country, after having earned or borrowed a credit in some other on-gold country, manipulates its internal credit and prices (and possibly controls imports and its foreign exchange market as well) so as to keep its exchanges fixed at the selected rate with the fulcrum country.

2. *The Need for Guarantees—which cannot be given.*

The next difficulty in the way of effecting a general or even a partial return to gold is that it is no use going back at all unless the gold standard rules are going to be properly observed in the future.

The gold standard depends for its successful operation:

1. On unimpeded gold movements.
2. On a resultant bilateral change in the price levels of

both the countries, *i.e.* on deflation in the debtor and inflation in the creditor; and

3. On the creditor country not putting on tariffs to prevent an additional influx of now cheaper foreign goods.

In practice, however, the modern politician and banker is most unwilling to play the game according to these three rules.

Firstly, they object on principle to inflating and deflating internal prices, and thus making the internal money unit unstable.

Secondly, debtor countries are afraid to export gold (and tend to borrow extensively abroad rather than allow gold to leave them). This prevents the needed gold deflation at home, and also the needed gold inflation abroad.

While, thirdly, the debtor country, in its desire not to lose gold, usually imposes tariffs so as to check imports which might have to be paid for with further exports of gold. While the creditor country, in its desire not to have goods dumped upon it, also puts on tariffs.

It is thus in practice economically impossible to get the gold game played correctly, and incidentally almost out of the question for any democratic government to give any of the guarantees which in theory and in practice are required before any safe return to the gold standard can be made.

3. *The American Difficulty.*

Another practical difficulty at present confronting any organised attempt to return to the gold standard immediately, is the difficulty of obtaining American co-operation. The American government is (1935) determined to revive its trade, if necessary, by means of inflation; but if it pegs the dollar on gold at a rate which is reasonable according to present ideas as to what is the appropriate purchasing

power parity, any subsequent inflation which may be necessary in the States will raise internal American prices, make American goods dearer to foreigners, make foreign goods cheaper to Americans, involve America in an adverse payment balance, and lead to the loss of much gold by America.

Hence, until it has once more got its 8,000,000 unemployed to work again, the American government will be unwilling to stabilise its dollar at any *permanently* fixed rate, at all close to the *present* apparent purchasing power parity, for it will want to keep up its sleeve the power to inflate if the stimulus of further inflation proves necessary.

America could, of course, and indeed might, return to gold at once at a *permanently* fixed rate which made her dollar apparently some 20 per cent. to 40 per cent. undervalued to start with; but (if they were asked) other nations like England would refuse to agree on such rates. Indeed, if American behaved in this manner, England would almost certainly stay off gold, for she would not want to be undercut for some years on end by artificially cheapened American manufactures, lest the same thing occur to her in respect of American competition as occurred in respect of the artificially undervalued gold franc from 1925 to 1931.

Indeed, if America suddenly devalues the dollar from the present level of \$35 per ounce to, say, \$41·34 per ounce, France herself might come off, so as to retaliate, and the gold tangle would be further increased by a competitive race for devaluation. This possibility is discussed in Chapter XX.

No early general return to gold at *permanently* fixed (as distinct from variable) parities is therefore likely (except perhaps by America at ridiculously undervalued rates; and this at present seems unlikely) until America has solved her problem of internal bad trade and unemployment. Variable rates are not Stabilisation; their significance is discussed in Chapter XX.

4. *The risks of being the first Country to act.*

Even though it may in the future, as at present, be the declared object of many countries to get back to gold, at *permanently* fixed rates, as soon as possible, action by individual powers in advance of others is a highly risky proceeding.

This factor is likely to prove perhaps for all future time the greatest impediment to a general return to gold currency, and the chief factor which may gradually cause gold currency to slip out of use.

Just as in 1926 France returned to gold at a parity which undervalued the franc by about 10 per cent., thus enabling her to undercut the gold prices of other competing countries, with the result that she captured both their trade *and* their gold, so, if one valiant country, or pair of countries, to-day returns to gold in advance of the others, there would again arise the risk of other countries, let us say Japan, subsequently undercutting her at some still lower gold rate.

England, for example, has already had sufficient experience of taking the initiative. She stupidly fixed an overvalued rate for herself in 1925, and then later saw another competing country, France, fix a positively undervalued rate in 1926. Safety obviously lies in being the "last" to act, for those who act first take the old English risk of other countries fixing at still lower rates; *i.e.* of overvalued exchanges; of dumping by foreigners; of loss of export trade; of loss of gold; of gradual deflation; of growing unemployment; of unbalanced budgets; and eventually, after a long and entirely useless struggle, of being forced off gold once again!

In view of these dangers, already well known, of being the first to act, the only probability of any return by individual nations to gold at *fixed* rates seems to be if combined and international action is taken *simultaneously.*

5. *Failure to agree concerning New Rates.*

Imagine, however, the finance ministers of the world assembled in gold conference say, in London or Paris. They

would all piously agree that new rates ought at once to be fixed, but each and every individual minister would be trying to obtain for his own country a rate which would provide it with some element of under-valuation. America would tell England that she ought to return at a rate of, say, \$6 to the £. England would say that \$4 was high enough. Other pairs of countries would similarly dispute, and no one would be able to agree; especially as no index exists to show what the correct equilibrium rate really is (see Chapter VIII).

Nor will any finance minister be willing to submit the decision to arbitration lest he be accused, on returning home, of betraying his country's interests "to the foreigner."

Optimists may, of course, argue that I am taking a much too pessimistic view of the broad-mindedness of statesmen when I say that "each and every individual minister will be trying to obtain for his country a rate which would provide it with some element of under-valuation. Nevertheless, the British Chancellor of the Exchequer has habitually indicated that the policy of the off-gold British Government, if and when sterling was stabilised, would be to ensure that sterling was not *over*valued in relation to *any* of the major currencies. Whether or not any currency would be overvalued in terms of sterling was regarded as the concern of the countries in question. Indeed, until December 21st, 1934, it was considered desirable that the pound should be stabilised at a level at which it would be undervalued to a reasonable degree in relation to *all* the important currencies.

But on December 21st, 1934, Mr. Chamberlain made a speech in the House of Commons which indicated a change of attitude; for he not only made it plain that there could be no question of stabilising sterling so long as it was overvalued in terms of dollars, but he also indicated that Britain would hesitate to return to gold so long as sterling was undervalued in terms of francs. As Dr. Einzig pointed out, Mr. Chamberlain's objection to the dollar being undervalued was in accordance with the policy *previously* pursued, even though

this rather narrow view was contrary to the normal British attitude which has always regarded prosperity abroad as a condition of prosperity at home; but Mr. Chamberlain's objection to the franc being *over*valued in terms of sterling was an entirely *new* attitude.

Dr. Einzig, however, went on to argue,* I think wrongly, " that this provided the prospect of any new Stabilisation Conference being no longer an 'auction of under-valuation' where each party would be trying to outbid all others, but rather a 'technical inquiry' to ascertain the exchange rates at which prices in various countries would be in reasonable equilibrium with each other, and whose adoption at new parities would involve no deflation."

Unfortunately, however—although Dr. Einzig and a great many others do not seem to realise it—it is not statistically possible to conduct a " technical inquiry " of the above nature on sound lines. Firstly, it is not statistically possible to determine the exact purchasing power parities between two different countries (see Chapter VIII). While, secondly, even if it were possible to make this computation, there is no guarantee that this purchasing power parity is the true equilibrium rate as regards both international trade and finance. It is, in fact, possible for differences in international tastes for different types of commodities to cause the imports of a country continuously to exceed its exports, even though the exchanges are at true purchasing power parity. Consequently, there may be some " Taste-tilt " which ought permanently to be allowed for.

Moreover, debtor countries, when they begin to pay their old debts, *must* have lower exchange rates than their creditors if a surplus of exports is to be developed so as to earn the foreign currency needed to repay the debt; while similarly if creditor countries begin a process of lending they likewise must have an exchange rate with a tilt on the downward side.

To imagine that these factors (present or future) can be

* In the *Financial News*, January 24, 1935.

measured by a "technical inquiry," when in reality they can only be measured by a process of trial and error, is mere foolishness; and every economist and market expert with more than a smattering of foreign exchange theory ought to be aware of it. Guesses may, and perhaps will, be made; but the guesses may be wrong; and that is why I maintain that each finance minister, at any new Stabilisation Conference, will, if he is alive to the issues, be "trying to obtain for his own country a rate which would provide it with some definite element of under-valuation which is beyond all reasonable doubt, *despite* statistical uncertainties." Obviously all countries cannot obtain this advantage in relation to all others; yet this is what each country will be striving for.

After much argument, therefore, any new Gold Currency Conference would almost certainly break down. Meanwhile paper will continue to be used, and a fairly satisfactory forward exchange market will doubtless gradually be built up as in the early 1920's (see Chapter X), because there will be profit in it. It will then, perhaps, gradually come to be realised, for reasons which we summarise in Chapter XIII (and which by then may receive much more general acceptance than they do at present), that despite certain advantages, fixed gold exchanges are economically unsound, and are in practice less satisfactory than paper from the point of view of the *general* economic welfare of the majority. The so-called "currency cranks" of a former period will perhaps by then be regarded as sensible and practical, and as hitherto misjudged, economists. Indeed, a policy of gold re-stabilisation will probably by then have come to be regarded as synonymous with a policy of re-depression.

In practice, we repeat, no nation will probably dare to take the lead except at ridiculously unfair rates—which will merely force the others to stay on paper or resort to a long-drawn-out competitive devaluation race.*

* If the reader disbelieves the trend of these remarks, let him open his eyes and ask himself, "What is happening almost imperceptibly, other than this, in Europe and elsewhere to-day?"

As regards the second alternative, namely international agreements to return *simultaneously*: it will quite probably prove impossible for the nations all to agree to new rates—and the public will probably no longer demand them, if trade revival is already occurring under paper currency! Thus gold in many countries may continue to remain out of use, although the central banks of the world will still be showing large holdings of gold as nominal assets in their balance sheets, and still be paying "lip service" to gold.

6. *Summary.*

Even if all governments continue to assert "outwardly" that gold is better than paper, and even if they all remain "nominally" anxious to return, the practical difficulties of:

(1) Gold redistribution,
(2) Guarantees as to observing the strict rules in future,
(3) Waiting till America has cured her unemployment, and
(4) Arranging a *simultaneous* return after first obtaining collective agreement as to new rates,

seem likely to lead, in practice, to a failure to return, even despite the existence of a generally "professed" desire to do so.

Gold may thus remain out of practical use in a large number of countries; and the public's belief in any future return to gold may gradually dwindle. Hoarded gold may then be gradually unhoarded, and the metal steadily dumped upon the remaining on-gold nations; gold inflation may then occur in these countries, unless sterilised, and their commodity prices may rise even faster than those of the off-gold countries.

Indeed, if *too* much gold is dumped upon the on-gold countries by foreigners, or if their internal prices begin to rise *too* fast (as seems not impossible despite probable attempts at sterilisation), they may, in succession, actually put on gold import embargos (as Sweden did from April 1924 to April 1930), and the world price of gold may gradually decline.

All this may seem quite "out of the question" at the moment, but this is the way in which events already appear to be imperceptibly developing in front of our eyes.

Make a list of your objections to my argument. Then go over the contents of this chapter, and re-test their validity.

You may perhaps say it is all "far too logical";—but is not this slow-motion picture, as I have described it (in speeded-up words), being shown to the world-public at this moment?

PART III

GOLD COMPARED WITH PAPER

CHAPTER XII

THE SIX DISEASES OF MONEY

1. *The Monetary Reforms prevented by Gold.*

Having considered the way in which the gold standard breaks down in practice, and the practical difficulties of securing any general return in view of the experiences of 1925, let us now consider not the positive harm that the gold standard does, but the cures to bad trade which it positively prevents.

(*This is perhaps the most important chapter in the book. It shows that to pave the way to permanent prosperity gold standard methods* must *be abolished.*)

2. *General Industrial Fluctuation expressed in terms of Money.*

Modern industry undoubtedly suffers from recurrent waves of *general* depression. There must be causes; and since nearly all industries are affected simultaneously the cause probably lies in some generalised factor, such as mass psychology, or in some factor common to more than one market, *e.g.* not the particular commodities produced but that which is generally given in exchange, namely money.*

In terms of goods, depression is a disease of demand rather

* I want the reader to note this point carefully, since many bankers, for instance Mr. James Warburg of the Manhattan Bank, positively assert that the depression is "not a money trouble."

than of supply, for abundance *should* cause prosperity. In practice, however, despite an abundance of goods, monetary demand becomes deficient either because consumers lack adequate monetary purchasing power, or because they will not use it, or because it is so unfortunately distributed that the ability to purchase is too widely separated from the desire to purchase.

Depressions can, however, be interpreted not only in terms of the supply and demand for goods, but also in terms of the supply and demand for *money*, and this method of examination provides the simplest (and most accurate) explanation of *general* fluctuation in almost all industries simultaneously.*

In terms of money, general depression might occur either because there was not enough money, or because the demand for it fluctuated; *i.e.* because it was alternately hoarded and dishoarded. This question of a fluctuating demand for money is of *vital* importance, although economists have neglected it most shamefully.

3. *The Influence of a Changing Demand for Money.*

Assuming the supply of money to be stationary, variations in the demand for money will impinge on the commodity markets in the following manner:—An increase in the demand means a competitive mass attempt, first to part with goods for money, and secondly to hoard such money as is obtained. The first tendency leads to a fall in prices: the latter to a decline in the flow or velocity of money *vis-à-vis* goods; *i.e.* in the *volume* of trade as well as in the price level. The disease of general bad trade *may* therefore be found in something connected almost solely with the "demand" for money; although if supply also happens to be fluctuating the disease may be found in supply; or in both.

A careful analysis of our modern monetary mechanism leads to the conclusion that money suffers from six major diseases, some of demand and some of supply, the cures to *all* of which are all positively prevented by the use of a rigid gold standard.

* Non-monetary factors are discussed in full in Volume III of this Series.

Indeed, it is these six monetary diseases which seem mainly * responsible for the periodic unemployment of capital and labour, and for recurrent periods of low profits and reduced production. These six diseases may be stated as follows:

4. *Disease I.—The supply of metallic money does not keep pace with the long-term industrial demand.*

Although productivity and population may rapidly increase, there is no means of arranging that gold production shall increase at the same rate. Sometimes gold increases too fast; sometimes it lags behind.

Indeed, in cases where gold reserves are being fully used by the banks, industry, in order to march further forward, has to take one step back; for without extra gold, prices have to fall if more trade is to be done. The fall comes about through bank credit restriction. In this way, a period of bad trade has usually to occur before more gold production is stimulated by a fall in costs. The disease, in fact, is that industry sometimes gets gold-bound.

Is it sane to tie prosperity to a metal whose supply is only adjusted to demand with a lag? Moreover, during the lag there *must* be a trade slump!

5. *Disease II.—Although the short-term demand for money as a store of value fluctuates considerably, short-term supply is not usually adjusted accordingly.* (A joint disease of Demand and Supply.)†

The demand for money is of two sorts: (i) as a Medium of Exchange; (ii) as a Store of Value.

The medium-of-exchange demand obviously fluctuates with the volume of trade. The store-of-value demand, however,

* Non-monetary factors are discussed in full in Volume III of this Series.

† In the supply of money, I, of course, include bank credit as well as legal tender, just as when I talk of traffic I include motors, even though they are merely a "convenient substitute" for horses.

fluctuates (i) with general price expectations and (ii) with general confidence.

As regards price expectations: Business men and consumers both obey the Law of the Falling (or Rising) Market. If consumers expect prices to fall, they hold off the market in the *hope* of a decline; if middlemen and producers have the same expectations, they hold off the market in the *fear* of a decline. Both tend to reduce their activities; both hoard money and increase their store-of-value demand.

Similarly as regards confidence: If people are nervous they like to be liquid and try to increase the amount of money they hold idle, or hoard. This reduces the flow of money offered in exchange for goods. Trade and prices thus tend to decline. Indeed, an increase in the store-of-value demand for money, resulting from nervousness, raises its value by lowering prices.

Theoretically, when an increasing demand for a thing raises its "price," supply ought to be stimulated, according to the ordinary laws of supply and demand. In the monetary sphere, however, no arrangements whatever exist for altering the supply of money in accordance with short-term fluctuations in the store-of-value demand. The normal law of supply and demand does not operate within the money market (a term which I here use literally instead of in the accepted sense of the Loan market). Thus, fluctuations in the store-of-value demand for money, arising largely out of changes in confidence, are one of the chief causes of business fluctuation. No arrangements exist to adjust supply.*

* * *

But there exists an even worse disease than this, namely, the additional disease, that just when supply ought most to be increased, to meet an increasing store-of-value (or medium-of-exchange) demand, it is habitually contracted.

* Fluctuations in the medium-of-exchange demand are *to some extent* met by fluctuations in supply. But even in this respect, the adjustment is only correct for a very small part of the business cycle. A brief statement of this case appears on p. 189, to which the reader might turn immediately.

6. *Disease III.—As the demand for money increases and general prices fall, the supply, instead of being increased (as it ought to be in accordance with the laws of supply and demand, so as to keep general prices,* i.e. *the value of money, stable), is normally contracted, thus giving cumulative downward momentum to all business depressions as soon as they have started.* (A cumulative disease of Supply.)

This third disease is not merely a negative sin of omission, as is Disease II, where the supply of money is not increased when the demand increases. It is rather a positive sin of additional commission in the wrong direction: namely, that *when supply ought to be increased, it is actually decreased.*

To explain: When prices begin to fall owing, say, to a decline in velocity of circulation, brought about by an increased store-of-value demand for money (Disease II), the resultant decrease in the market value of banking collateral causes prudent bankers to call in loans. The result is a positive deflation of the total supply of bank credit currency, just at a time when money ought theoretically to be increased!

Moreover, the initial calling in of loans leads to numerous forced sales and to still lower prices, and therefore to still more credit contraction by bankers. Indeed, a fall in prices due, say, to an increase in the store-of-value demand for money, tends to gather momentum owing to the prudent actions of bankers taken in the course of their duty. It is not the fault of the bankers themselves, but rather an institutional defect in the modern money system, which has the peculiar characteristic that the money used mostly by the public comes into being by means of bank loans, and is similarly cancelled. The result is that when supply ought theoretically to be increased it is normally * contracted, and the laws of supply and demand are thus infringed, making the whole currency and economic system unhealthy.

* During the prosperity stage of the cycle, before the banks have become strained, the supply of money is usually increased with the *medium-of-exchange* demand (usually too fast—at a time when the store-of-value demand is diminishing, but money is virtually *never* adjusted to fluctuations in the *store-of-value* demand.

The cure to the disease must obviously come, not from individual bankers themselves, who *must* continue to protect their deposits carefully, but from some central currency authority who, when it sees prices falling owing either to hoarding or to prudent credit contraction on the part of bank managers, will set in motion a counter-movement of an anti-deflationary nature, so as to counteract by *central* inflationary action the credit deflation which is taking place on the circumference of the banking system. (The technique to adopt is described in Volume I of this Series, where the best methods of injection and withdrawal of credit and legal tender are considered.)

7. *Disease IV.—The supply of money is largely governed by confidence.* (A disease of Supply.)

In addition to the supply of bank money being governed largely by market fluctuations in banking collateral, it is also governed largely by mass confidence.

As confidence varies so do borrowers expand (or contract) their bank loans, and so do banks increase (or decrease) their investments. The result is that the total volume of money in active circulation is to a large extent tied to an index of confidence. Fear itself may thus cause monetary deflation, and this is clearly an additional disease in the monetary system; for it leads to the supply of money being actually contracted just at those times when, owing to a fall in prices, due to hoarding, it ought theoretically to be expanded, so as to keep its value stable.

8. *Disease V.—The use of a dual form of money (legal tender and bank credit) gives rise to a Bank Credit Cycle.* (An institutional disease.)

This disease results from the fact that we use a dual form of money, *i.e.* bank deposits based on legal tender in a more or less fixed ratio.

Legal tender, when in circulation outside the banks, is used mainly for wage-paying, pocket-money and till-money purposes, *i.e.* for wages and retail trade. The economic results

of these monetary customs are unsettling. When trade declines and retail prices and wages fall, less legal tender is used outside the banks. More flows back into the banks; and this increases their reserves. The banks therefore tend, with a lag, to increase the size of their investments. Their purchase of investments actively expands the total bank credit currency, and injects more of it, as distinct from more legal tender, into general circulation.

This, with a lag, tends to improve trade, for the public, since their average idle money balances increase, tend after a while to spend their redundant money surpluses * on commodities. Then later, as trade improves, business men themselves begin to borrow more from their bankers. This means a further expansion of the bank credit currency and a further tendency towards still better trade.

When, however, factories and men become fully employed, retail prices are marked up and wages tend to rise. More legal tender is then taken from the banks. Bank reserves become strained. Bank investments and loans are contracted.

Credit deflation thus begins, and a downward swing in the trade cycle is started. Disease II, *i.e.* hoarding owing to lost confidence, thereupon breaks out; and the depression is soon made cumulative because of Disease III, *i.e.* progressive bank credit contraction. Thus, an initial increase in the demand for legal tender outside the banks, resulting from prosperity itself, leads to strained banks and a slump!

Fortunately, however, depressions tend to be self-curative, for depression itself breeds the seeds of its own revival. A fall in retail trade and wages reduces the demand for legal tender outside the banks, and banking reserves are consequently restrengthened. The credit cycle just described is then once more repeated.

What causes this cycle of fluctuation is not precisely the use of a dual form of currency †; but rather the customary time-lag

* See Appendix A.

† Although the disease would *not* occur if there were *not* a dual form of currency.

which occurs between credit expansion and consequential cash withdrawals from the banks (and between credit contraction and the consequential cash returns). If these time-lags did not exist, Disease IV would merely assume the nature of Disease I, *i.e.* a simple shortage of legal tender. It is the time-lags which induce bankers to overdo both the credit expansion and the credit contraction, thus setting in motion a business cycle.

I am not complaining because a dual form of currency is used; indeed, it is convenient. I am, however, complaining partly that bankers allow the fluctuations to go too far, but mainly that an expansion of prosperity is sometimes not merely held in check, but also *reversed*, even though price inflation is *not* occurring, solely because prosperity requires more legal tender, and this extra legal tender has to be taken out of the banks, and they are consequently weakened. The Disease, in fact, though similar to Disease I (*i.e.* monetary shortage), is not precisely identical. It is, however, a disease of the "supply" of legal tender which ought to be remedied if prices are *not* rising.

This disease, I should emphasise, is a banking disease, and may occur under paper just as much as under gold.

9. *Disease VI.—The exportability of banking reserves.* (A disease of high politics.)

The next major disease of money, which applies only to the gold standard, is that, even though all metallic banking reserves may be in full use internally, any casual deficit in the international payment balance (resulting from the haphazard loans, investments and commodity imports of the international trading and financial community) may cause part of the essential banking reserve of the country to be suddenly exported, thus setting in motion internal credit currency contraction perhaps to nine times the volume of the gold exported—thus causing a wave of bad internal trade. Such a fall can be set in motion even though internal prices are not rising harmfully.

It appears politically ridiculous and economically criminal

that the haphazard actions of a few international traders or financiers should be allowed to upset the whole internal currency system of a country. Indeed, as Dr. Einzig says in *The Future of Gold*: "The exportation of a few million pounds' worth of gold may cause hundreds of thousands of men to be thrown into unemployment as a result of the consequent credit contraction."

10. *Suggested Cures.*

Having pointed out the nature of these six monetary diseases, the problem arises of suitable cures. In Volume I of this Series they are fully considered, but briefly they may be stated as follows:

Disease I. To get rid of the disease of gold production either outstripping or falling short of economic development, gold must be either spasmodically sterilised * or devalued.

Disease I, under a rigid automatic gold system, makes steady industrial progress dependent in the main on gold discoveries. Indeed, it is only if real industrial costs are progressively reduced, or if economies of the metal are effected by banking refinements; that a check to the forward march of industry will not mature. It ought, however, to be possible for industry progressively to expand, even if real costs are stable. Shortage of gold, however, frequently prevents it.

Disease II, namely, sudden increases in the store-of-value demand for money, is inherent in any community subject to mass psychology. This unavoidable disease can, however, be counteracted effectively by deliberate manipulation of the supply of money. The currency authority should, in fact, watch the price index, inflating when prices begin to fall and deflating whenever they rise. His action should be like that of a skilled chauffeur, who continually turns his steering wheel right or left as his car swings too far left or right. He should keep his hand continuously on the wheel and his eye on the road, *i.e.* the price level.

* Or lowered in statutory price.

Disease III, cumulative bank credit contraction, is inherent in our collateral bank-lending system; and individual bank managers themselves cannot avoid it in a community which happens to use as money the pass-book entries which come into being and are subsequently wiped out by fluctuations in bank loans and investments.

The cure to this disease must obviously come not from individual bankers, but from some central authority charged with the task of counteracting the actions taken by prudent individual bankers.

The cures to Disease IV are identical with those to Disease II.

Disease V, *i.e.* the Bank Credit Cycle, merely requires that more legal tender should be provided or made available, when banking reserves become strained, *provided that* the price level is not rising. All that is required is that prosperity should not be held in check solely for lack of legal tender—provided that there is no price inflation.*

Disease VI, *i.e.* the exportability of bank reserves, can best be cured by refusing to use an international and therefore exportable currency like gold. An exportable currency, though good for foreign traders and financiers, is bad for the rest of the community.

11. *Reforms prevented by the Gold Standard.*

Looking at these several diseases jointly our conclusion must necessarily be as follows:—If the fixed gold system is retained it will not be possible to institute any of the monetary reforms which are so necessary to iron out the above-mentioned fluctuations of business activity and employment; for under gold it would be quite impossible to inflate credit, so as to keep prices

* The reader might, at this point, read p. 189.

up, if at the same time it should be necessary to deflate so as to correct the exchange position. Stable money and stable exchanges are mutually incompatible. The international use of gold prevents internal price levels from being kept stable.

The use of gold prevents the Laws of Supply and Demand from having their effect in the monetary sphere, where, more than in all other spheres, they ought to work satisfactorily—variations in demand being promptly met with variations in supply, in response to changing "price." Gold therefore, in addition to being a powerful cause of bad trade, also largely prevents the institution of those monetary reforms necessary to secure continuously high profits and employment.

Further proofs of these contentions are contained in Volume III. Gold prevents the cure to Unemployment!

. . . . . . *And that is precisely why I have written this book.*

It is impossible, in view of our modern banking system and monetary habits which have grown up out of past history, either to cure unemployment or to have continuous *good trade until the* international *gold standard as we know it is abolished. It is gold that primarily blocks the path to prosperity. If you do not believe me read through the last part of this chapter once more. There are six subtle diseases in the monetary system. They are certainly the cause of recurrent unemployment and continuous poverty. They cannot be cured under an* international *standard. The gold standard as we know it must therefore be abolished.*

To get rid of the gold incubus must in fact be the first objective of those who wish to cure unemployment and to prevent the anomaly of plenty causing want instead of prosperity.

CHAPTER XIII

THEORETICAL DEFECTS IN THE GOLD STANDARD SYSTEM

1. Introductory.
2. The gold standard prevents the proper economic adjustment of the supply of domestic money to the demand.
3. The gold standard involves industrially harmful violation of the law of supply and demand in the foreign exchange market.
4. A stabilised gold standard is unsuitable to a capitalist country with an inelastic wage and cost level.
5. Gold as a cause of recurrent general trade fluctuations. Industry becomes gold-bound.
6. Secular price fluctuations due to a changing demand for money or to mining discoveries.
7. The gold standard spreads financial diseases internationally.
8. Summary of the case against gold.

In Chapter VI we showed:

(*a*) That if the nations return to the gold standard, but do not play the game according to its rules (namely, no hindrance to gold movements, no tariffs to prohibit the movements of goods, and willingness to deflate or inflate according as gold is lost or gained), the gold standard will once more break down;

while in Chapter VII we showed:

(*b*) That even if it were the general desire of all countries to return to gold shortly it would be difficult for them to agree to mutually satisfactory parities; while—

(*c*) It is impossible to give and obtain the guarantees which are necessary before a general return to gold can be made with any prospect of safety or success.

* * *

1. *Introductory.*

Although there is a strong practical case to be made against the gold standard:

(*a*) Because governments refuse to play the rules correctly,
(*b*) Because even if the rules are played correctly, the economic results are often most painful, and
(*c*) Because it prevents the institution of monetary reform;

the theoretical objections seem even more conclusive.

The gold standard, although superficially attractive, is actually one of the clumsiest and most harmful pieces of economic machinery that the Goddess of Evolution has ever devised. The reason is that the gold standard, even if worked strictly according to theory, entails so much unhealthy violation of the law of supply and demand, not only in the foreign exchange market itself but also in the realm of domestic money, as habitually to bring about periods of general bad trade, low profits and unemployment. Let us consider these two cases:

1. In the foreign exchange market the laws of supply and demand are disregarded owing to "price" being artificially pegged by the gold mechanism, despite the existence of violent short and long run fluctuations both in supply and demand, calling for quick correction; and

2. In the realm of domestic money itself the laws of supply and demand are also ignored because the orthodox pursuit of gold standard principles positively prevents the adjustment of the supply of money to fluctuations in the *internal* store-of-value and medium-of-exchange demands (see Chapter XII and Appendix A), as reflected by movements in the price level.

Indeed, to my mind, it is these two rather subtle faults in our modern monetary system—both of them an unhealthy violation of the laws of supply and demand—which are the chief causes of unemployment and depression in the modern world.

The subject, it is true, is involved and complex, but in view of its vital importance to every individual in the nation, from the unemployed worker to the equity shareholder, its study is well worth careful attention.

The theoretical arguments against the gold standard are

sixfold—and if the objections are sound in theory, they must be sound in practice also.

2. *The Gold Standard prevents the proper Economic Adjustment of the Supply of Money to the Demand.*

The first theoretical objection to a rigid gold standard—and to my mind a vital one—is the already mentioned fact that it prevents the institution of those monetary reforms which alone will alleviate and prevent the disease of cyclical unemployment. The reader, of course, is not expected to accept this statement at its full value until he has read Volumes I and III; but the fact is that a fluctuating internal price level upsets trade, and the gold standard " requires " a fluctuating internal price level; for instead of the supply of money being adjusted to demand, so as to keep the price level stable, it has to be forcibly adjusted, not so as to keep prices stable but so as to make them move, in order to keep the exchanges stable.

The result is an unstable standard of values and violent fluctuations in profits, trade and employment.

The disease, in a word, is that the laws of supply and demand are not allowed (owing to the gold standard) to operate properly in the realm of money, *i.e.* in the one particular sphere where economic health is perhaps more important than in any other.

This disease can and often does occur even in the absence of a fixed gold standard, for it is an inherent (though curable) disease in the modern bank-money system. The truth is, however, that it cannot be cured by any country whose money is rigidly based on gold, for any internal attempts to check deflation will, unless the rest of the world keeps in step, cause the country doing so to lose all its gold. Rising prices (or stationary prices, if foreign prices are falling faster) will stimulate imports and discourage exports, with a resultant strain on the exchanges of the country. Under gold, this means the eventual loss of the country's gold stocks; under paper, merely a movement of the exchange against the country in question, which will

automatically regulate her balance of trade, while the necessary internal measures against deflation can continue unaffected.

That is why, in order to prevent cyclical deflations and the accentuation of cyclical unemployment, it is necessary to cease tethering currency immovably to gold.*

3. *The Gold Standard involves industrially harmful Violation of the Law of Supply and Demand in the Foreign Exchange Market.*

The second major theoretical objection to the gold standard is that which we have already described in some detail, namely, that it involves an unscientific attempt to defy the natural laws of supply and demand in the foreign exchange market itself.

Since there has to be *some* form of economic corrective in the foreign exchange market, obviously somebody has to suffer, but the question is, Who ? On economic grounds it is surely much better for the corrective to mature quickly and naturally in the form of a fluctuating exchange rate, which *quickly* makes international traders and financiers correct their previous inequalities, rather than via the more ramified and unfair process which upsets the whole internal price structure and with it the real burden of all money debts ? A fixed gold standard would seem economically unscientific, as well as peculiarly unfair.

It is the international trading and investing community whose unequal actions upset demand and supply in the foreign exchange market (and whose eventual actions can alone effect a readjustment), and they therefore—since some one has to suffer—should, in the main, be made to suffer for irregularity of their actions.

It is strange, too (and to me quite unsound), that in a market where haphazard demand and supply are by their very nature repeatedly unequal, a government should arbitrarily step in and, by means of its currency system, maintain a permanently fixed price, thereby divorcing that market from the direct and healthy corrective influence of the law of supply and demand,—and that,

* Simultaneous action by all countries is impossible. See Chapter XIX.

by this action, the government in question should deliberately cause everything else to fluctuate, for the benefit of the rather pampered international community; especially when the fluctuations in " everything else " mean inflicting on the general community the subtle burden of unstable money—despite the fact that it is the duty of a government to provide its people with stable money.

The mass of the people, however, being ignorant of these matters, do not understand the basic causes of the continuous internal price instability which the gold standard entails. They merely see that stable exchanges are desirable *per se*, and therefore argue that anyone who advocates fluctuating exchanges must be a crank. They do not perceive that stable exchanges automatically require and involve unstable prices. And it is just as " cranky " to demand an unstable standard of value as to demand unstable exchanges. The fact is, however, that the case for stable exchanges is usually accepted as sound and is rarely disputed, even by its victims.

Talking of cranks, the following point may be interesting. Already there exist, at the Treasury, in the Universities, on the Boards of the five great Banks, and even on the Court of the Bank of England, men who assert that stabilised money is a prime necessity for enduring prosperity. The point at issue is therefore this: If it is true, as these gentlemen assert, that a stabilised internal price level is a prime necessity to prosperity and if it is true that internally stabilised money is not compatible with the gold standard, are not the gentlemen who advocate internal stability, (perhaps unconsciously) advocating the abandonment of gold? Are they too " cranks," or are they not aware of the secondary implications of internal price stability?

(Or do they believe that, in the absence of an international bank credit currency, stable prices and stable exchanges are mutually compatible?)

4. *A Stabilised Gold Standard is unsuitable to Capitalist Countries with Inelastic Wage and Cost Levels.*

Looking at the fundamentals of the gold standard system, the very essence of the standard is this: that if the balance of payments is adverse, gold shall move and that internal prices shall become deflated in the debtor country.

But the first shock of a credit and price deflation always falls upon business profits.

In modern capitalism, however, profits are the mainspring of industry; and if they are reduced, or even threatened, by tight money, business men will reduce their enterprise. Employment in consequence will begin to decline, money will be hoarded, and all the forces of a vicious deflationary spiral will be set in motion—merely in the hope that, at last, the comparatively few commodities which enter into international trade shall become sufficiently deflated in price eventually to attract foreign buyers.

This would not matter if it were possible to reduce all costs *pari passu* with prices, simultaneously and by an equal proportion. Most costs, however, including labour, are relatively rigid, and it is thus impossible for costs to fall parallel with prices. Selling prices therefore tend to fall below the relatively rigid and undeflatable cost level, with the result that the sudden deflation of prices and profits upsets business confidence and brings trade to a standstill.

And yet this is precisely what the gold standard requires and presupposes: a deliberate *general* deflation of profits and employment.

In other words *all* trades are made to suffer indiscriminately in the hope that the few export trades among them may eventually be forced to cut their prices.

Certainly if the bankers pursued a *selective* policy of deliberately squeezing the export trades *only*, the gold standard might not be so bad; but the squeeze is put on the whole of industry (by open-market operations, high bank rates and credit restric-

tion) and the *whole* of industry is made to suffer. To roast the pig a whole house is burnt down.

And why does this happen? Merely so as to provide the foreign trading and financial group (at the expense of the rest of the community) with the amenity of fixed exchanges, which in themselves are artificial and uneconomic in a market wherein demand and supply themselves fluctuate violently!

People do not realise this indisputable truth; they therefore are inclined to support the gold standard. Slowly, however, the world will learn not to allow itself to be crucified on an international golden cross.

The authentic gold standard would, I admit, not be so bad if profits were *not* the mainspring of industry, or if wages and numerous other costs were *not* rigid; but since they are, the gold standard as such is entirely unsuitable to capitalistic countries operating the modern wage system and subjected to fixed long-term rents and numerous other absolutely rigid and inelastic overheads.

5. *Gold as a Cause of recurrent General Trade Fluctuations. Industry becomes Gold-Bound.*

The fourth theoretical defect in the gold standard system is the point we raised in Disease I of Chapter XII. It is a disease of internal currency, namely, that, even if it were possible under gold to manipulate the supply of money in accordance with short-run variations in the store-of-value demand (see Appendix A), it would still be merely a matter of chance if the long-run supply of gold kept parallel with the general advance in population and industry.

Expanding trade requires more money; but if the banks, for lack of gold reserves, dare not expand credit any further, trade expansion is checked and economic progress becomes gold-bound.

The point is that under gold, since the supply of metallic money cannot be adjusted *at once* to the demand, the medium-of-exchange demand has to be adjusted to the available supply;

that is to say, prices have to be *made* to fall by means of bank credit deflation (so that the same amount of gold will be able to do more commercial work) before any further economic advance becomes possible.

Admittedly falling commodity prices, by reducing mining costs, themselves eventually stimulate the output of gold and increase the supply of currency, but the ridiculous fact is that *before* this beneficial (and negligible) adjustment " of supply to demand " is effectuated, prices have to be deflated (and demand adjusted to supply), thus producing a slump in trade.

Industry, in fact, through using a metallic currency, has from time to time to take one step back before it can advance a further step forward. Cyclical swings in trade are thus caused, and industrial progress is impeded. Modern progress is thus very largely held in check by the scarcity of gold.

For this reason many economists argue, and seemingly rightly, that for currency to be tethered to any single commodity, particularly a scarce metal like gold, is unsound, since it cannot be expected obligingly to increase *pari passu* with general industrial activity and with the demand for it. A metallic standard, so they say, is on the face of it unscientific, for it tends to make industry depend on chance discoveries of a metal. At one time it fortuitously gives rise to harmful inflations; at others to unwanted and dangerous gold deflations. Deliberately controlled paper and bank credit is, they say, more scientific and serviceable.

Even the modern (American) policy of occasionally altering the nominal gold content of currency notes (so as to economise metal) may be objected to on the following grounds: (i) that there may be too long a time-lag before action is taken, and (ii) that a competitive devaluation race may occur between nations, as will be explained in Chapter XIX.

Or, to summarise this section: the existence of the gold standard gives rise to a business cycle,* since industry has from

* Volume III will explain that there also exist several other reasons for the business cycle. *N.B.*—Some forms of trade fluctuation are cyclical and self-generating; others are merely spasmodic.

time to time to take a step backward before it can take any further steps forward.

6. *Secular Price Fluctuations due to a changing Demand for Money or to Mining Discoveries.*

The fifth theoretical objection to the gold standard system is that it causes "secular" disturbances, which are peculiarly upsetting to all long-period contracts arranged in terms of money.

It is true that gold prices in England * were practically the same in 1826, 1841, 1855, 1862, 1867, 1871 and 1915, but nevertheless prices fell 20 per cent. from 1820 to 1850; rose 10 per cent. from 1851 to 1872 (due to the gold discoveries in California and Australia); fell 26 per cent. from 1873 to 1895 (due to Germany adopting a gold standard instead of silver); and rose 30 per cent. from 1896 to 1914 owing to the South African gold discoveries.

Fluctuations in world supply or demand thus brought about serious and harmful secular changes in prices; † and it was only by fortuitous mining discoveries that prices happened so frequently to cross and recross the same line.

The trouble about any metal used as a basis for currency is that there exists no reason why the supply should increase *pari passu* with general industrial production or demand. Either supply runs ahead of demand (and causes an upward trend in prices) or else it lags behind (giving rise to deflation).

The result, moreover, is an unjust alteration in the real value of all long-range contracts such as rents, mortgages, annuities, government debt, insurances and so on.

Tying currency rigidly to a metal whose production fluctuates according to mining discoveries or changes in mining technique, is definitely a defect in the authentic gold standard system.

* Sauerbeck Index.

† During the upward secular swings the booms were prolonged and the slumps shortened. During the downward swings the cyclical slumps were prolonged and the periods of prosperity were very short.

In the past gold has certainly played an extremely useful part, first in eliminating the inconveniences of barter, then later in building up the modern banking system, and finally in providing international trade in the nineteenth century (before managed paper was understood) with a helpful international standard of value under London control. But its defects, with London no longer the world's chief creditor, are so serious that the time may now have arrived when this old and honoured economic servant should be replaced, for the sake of progress, by controlled paper money. Just as horses have been replaced by cars, so perhaps should " natural " metal now be replaced by " artificial " paper, even though gold has itself played a big part in developing and perfecting this now more promising substitute.

7. *The Gold Standard spreads Financial Diseases Internationally.*

The sixth main defect in the gold standard is its tendency to spread economic and monetary diseases prevailing in one part of the world to other parts, despite all efforts to prevent it. Mr. R. G. Hawtrey has explained this very well in his book *Trade Depression and the Way Out.*

If prices slump in one important country, owing to a banking collapse, credit contraction, etc., this will probably cause an influx of gold from other countries which are otherwise prosperous. If the gold reserves of the latter are being used to the full by the banking system, credit will have to be contracted, so that they too will suffer deflation *on account of* the deflation in the first-mentioned country.

This would not matter so much if the arrival of the gold in the first country quickly put an end to the deflation there, and produced an inflation which would cause the gold at once to flow back to the other countries. In practice, however, as described in section 6 of Chapter XII, a credit contraction, when once begun, tends to become cumulative and the downward movement of prices and business activity usually lasts for some years.

In this way it is possible for a fortuitous banking crisis occurring in one country, owing to poor banking management,

or a bad harvest, to spread the disease of credit deflation over the rest of the world via the mechanism of the international gold standard.

It is obviously absurd that a country should lose its metallic basis for currency, and thus be forced to suffer a credit deflation, merely because of fortuitous accidents, or bad bank management abroad.

Incidentally, I should point out that if one country is secretly preparing war against another, it could well accumulate or borrow large funds in the country which it was preparing to attack, and, just before its declaration of war, withdraw these funds in the form of gold, thus causing a banking panic in the gold-losing country. There is, in fact, considerable scope for offensive monetary manœuvres of this nature on the part of a foreign enemy.

* * *

Not only deflation but also inflation may spread from one country to another on the gold standard. If one country, for no matter what reason, inflates its internal price level, gold will flow abroad, thus tending to inflate price levels elsewhere.

It should also be added that if nervousness develops in one gold-using country, capital may be exported to another in the form of gold, thus causing deflation in the former and inflation in the latter.

Although from the point of view of international traders, investors and lenders it is highly desirable, other things equal, to have a rigid exportable gold currency, the very fact that credit is based on gold in a ratio of perhaps 10 to 1, means that a small international movement in metal may cause a huge national contraction or expansion of bank credit. There is, in fact, much to be said against any system under which reserves used for money are exportable at all, or are subjected to interference as a result of either fortuitous occurrences in the world outside, or of one-sided pressure in the balance of payments, arising out of the fortuitous mass actions of international traders, lenders, investors and speculators.

An international currency system is certainly desirable, and of all "*international*" standards of value gold is undoubtedly the best; but the defect in the modern currency system is that nowadays gold is only bank *reserve* money, upon which other forms of money are built up;* and this peculiar "geared-up" characteristic of the authentic gold system is the cause of the *rapid* spreading of industrial diseases from one country to another. This is an inevitable result of stable exchanges. Fluctuating exchanges would insulate one country from another.

Of course, if there were such a thing as international money a country would lose only 100 units of domestic money to pay a foreign debt of 100 units. Since there is no true international money, a country tends to have its internal quantum of non-international money deflated by about ten times the amount that would be needed if there existed internationally acceptable bank-notes and bank deposits.

The whole system is ridiculously and harmfully geared up; and the gearing becomes higher and higher as the banking system develops, and as gold is economised and no longer circulates internally.

Naturally, I should be the first to support truly international money, if it were *politically* feasible to institute a world banking system where the notes and bank deposits of one national area were accepted and passed current in another. Since, however, this is not *politically* possible (see Chapter I), I am averse to the continued use of the gold standard.

8. *Summary of the Case against Gold.*

Taking a broad view of the modern monetary system as a whole, the following points emerge:

1. The first desideratum is a stable internal measure of value. Gold currency has not provided this in the past, nor can it (if coupled with fixed gold exchanges), for the simple reason that the gold standard itself, for its proper working, automatically requires a fluctuating internal price level. There-

* In the nineteenth century, when deposit money was not so widely used, the defects of the gold standard were naturally not so evident.

fore *if* internal prices are to be stabilised, the fixed gold standard will *have to be* abandoned.

2. Another institutional fault in the modern currency system as at present worked is that instead of a fall in general prices, due, say, to an increase in the store-of-value demand for money, being immediately counteracted by an increase in the (credit) currency, the reverse is the case, and credit currency is habitually contracted; thus any casual fall in prices, when once begun, tends to gain momentum. A correction of this fault under the authentic gold standard is impossible.

3. Thirdly, under the gold standard system, not only is *internal* money unhealthily divorced from the law of supply and demand, but so also is the foreign exchange market.

Although the foreign exchange market is by its very nature repeatedly subjected to sharp short-run and long-run variations in both demand and supply, owing to foreign investment, political debts, casual excesses of imports, short-term lending and so on, the price of foreign exchange is artificially pegged by the government within the gold-points, and no *quick* corrective is allowed to mature. Sole reliance is placed elsewhere. The system on the face of it is economically absurd, and in addition to being unfair, is slow and harmful.

4. Finally, since it is logically impossible to have both stable internal prices and stable exchanges (so long as the countries of the world have separate banking systems), statesmen must choose between the two. According to our argument the fault in the money system—and it is this fault which primarily leads to trade slumps and unemployment—is, not that the quantity of money is not, and cannot be, deliberately manipulated, but that it is manipulated with the wrong economic goal in view: it ought to be manipulated to keep prices stable; but instead of that it is manipulated to make prices move. The modern gold standard is entirely wrong because it involves a policy of deliberately making money unstable—for a less important object, namely that of stabilising exchange rates.

Until these monetary diseases are cured we shall inevitably suffer from bouts of low profits and unemployment.

CHAPTER XIV

WHY ON-GOLD COUNTRIES ARE AFRAID TO COME OFF

1. The higher cost of imports and war debts.
2. The fallacious belief that going off gold must be followed by paper inflation.
3. How incipient sharp rises in prices would be checked.
4. Is devaluation dishonest?

HITHERTO we have been criticising gold from the point of view of a return by the off-gold countries. But in addition to the question of the off-gold countries "staying off," there is also the question of the on-gold countries "coming off."

1. *The Higher Cost of Imports and War Debt Payments.*

Most of the countries now on gold declare themselves strongly averse to coming off. In Germany, for instance, before 1933 I often heard such comments as the following: "Coming off gold always leads to inflation and we had enough of that in the early 1920's." Moreover, it was often added: "Germany is a poor country; we cannot afford to come off gold, for all our imports would cost us more, and the service of war debts would become more expensive. This would further unbalance our budget and might drive us along the road to another inflation."

Let us take the last point first. It is true, of course, that in terms of marks coming off gold would cost the government more to pay foreign debts and would raise the prices of imported raw materials; but what people fail to realise is that if Germany came off gold her exports would increase (for the mark is at present some 20 per cent. overvalued) and she would, with her exports, at once earn *more* foreign currency and would therefore be able to buy more goods from abroad, instead of suffering as

she does at present—under her controlled import system—from the lack of many desirable imports.

Admittedly she might import less of *some* things if mark-prices rose, but she would be able to import more of things *in general*, on account of her extra earnings abroad.

Incidentally, it is because Germany's export trade is ruined by an overvalued exchange that much of her internal manufacture is so depressed, even though imports are (too) cheap. Foreign debt service, it is true, would cost her government more "marks," but the government would receive more marks by way of ordinary tax revenue if the export trade and internal trade began to revive. Further, the domestic depression resulting from the deflation needed to keep debtor-Germany on gold costs more to the Exchequer in lost general tax revenue than the extra cost (in marks) which the foreign debt service would involve if she came off and reflated. If Germany revived her internal trade by reflation, the real burden of her foreign debt would be lighter, although its service would cost more in marks.

2. *The Fallacious Belief that going off Gold must be followed by Paper Inflation.*

Another factor which makes many gold-standard countries afraid to abandon gold is the belief that coming off gold will involve them in a bout of inflation similar to that which occurred in the early 1920's. Indeed, it is widely thought that external depreciation *must* be followed by internal depreciation as well, in a vicious and rising spiral.

This belief is widely held, partly because recent history looms large in the mind and partly because things having the same name are believed to be identical.

Internal inflation of the mark certainly constitutes "depreciation" of the mark. External devaluation is also a form of "depreciation." And since both can be called "depreciation," coming off gold is regarded as synonymous with inflation.

This, however, is due merely to the ambiguity of the word "depreciation," which happens to have two separate meanings. The ambiguity prevents people from seeing that although wild inflation *must* involve a decline in exchange rates, a decline in exchange rates need *not* involve wild inflation.

There is confusion between both the nature and the consequences of internal and external "depreciation."

The fact is, however, that an enormous number of people regard a fall in the (external) value of a country's exchanges and in its *foreign* purchasing power as being merely *another word for* a fall in its internal value or purchasing power—because both are obviously a "fall in value."

Others, while not going quite so far as this, nevertheless argue that, since going off gold makes certain imports dearer, and therefore raises certain home prices and perhaps the cost of living, more currency will be wanted and will have to be issued *in consequence*; and that therefore going off gold *must* lead to quantitative "inflation" (even though it may be admitted that "going off gold" and internal "inflation" are not quite the same thing).

These two beliefs, though widespread, are erroneous.

Certainly a 30 per cent. decline in an exchange rate will lead to a 30 per cent. rise in the cost of certain imported raw materials and foods, and this will cause some retail prices to rise. And certainly if this occurs, more legal tender notes may be required to drive the same volume of *retail* trade at the higher level of prices. In other words, a quantitative expansion of legal tender currency may be required as a result of depreciated exchanges.

This, however, is not an Inflation in the true sense of the word. The extra legal tender issued by the Central Bank would not remain *inside* the member banks as a basis for an additional superstructure of bank credit, but would circulate *outside* the member banks amongst wage-earners and retailers. The extra issues of legal tender paper would thus not have "caused" an inflationary rise in retail prices; they would

merely "*reflect*" a rise brought about by quite other factors. The extra paper would not be inflationary in its own effect, but merely anti-deflationary; for if the Central Banks were to *refuse* to issue more legal tender to the member banks, the extra legal tender taken from them by the public for pocket-money and till-money purposes (at the higher general level of prices) would denude the member banks of cash and lead to a positive *deflation* of credit on their part, which would reduce most prices and profits and be bad for general trade. In other words, any extra Central Bank emissions which followed devaluation would be anti-deflationary, not inflationary.

These extra emissions I should positively advise, as and when needed, in the case of countries going off gold, because deliberate deflation of prices would be undesirable in so far as they had risen only as a result of certain imports becoming dearer.

The example of England since September 1931 will convince the doubter that external depreciation does not necessarily involve internal inflation. In spite of the 30 per cent. depreciation of the £ in the foreign exchange market, there was no internal inflation whatever.*

3. *How incipient Sharp Rises in Prices would be Checked.*

Nor is there any theoretical need for the retail trade and banking experiences of Germany in the early 1920's to be repeated.

If retailers started marking up all prices strictly *pari passu* with declining exchange rates (as they did in Germany in 1923, though they did not do it in England when sterling collapsed in 1931), the rise in retail prices, since it would for the while be unaccompanied by increased wages and increased incomes, would lead to a diminution of consumption, and consequent competition amongst retailers to sell, and later to competitive

* Seven months later, in order to convert the War Loan, an 18 per cent. inflation of bank deposits took place, but this was a separate causation.

price-cutting on their part. The results would soon be a quick reaction in retail prices and little extra cash would *in toto* be kept by retailers out of the banks for ordinary till-money purposes. Meanwhile, no more cash would be taken from the banks for wage payments, if wages had not been raised; and there would be no inflationary expansion of the currency.

In other words, neither a banking crisis (due to cash being lost into general circulation) nor inflation by the Central Bank (so as to rescue the member banks who had paid out additional cash) would occur as a result of the deliberate unpegging of the exchange rates.

These currency factors, however, have been so consistently mis-stated and misunderstood throughout Europe, that on the principle that a given word, *e.g.* "depreciation," can have only one meaning and that history must always repeat itself, there is widespread belief that inflation *must* occur if gold is abandoned—a fear which was even felt in England when England first abandoned gold! (Which was rather nonsense in view of the easily balanced Budget—as I ventured to point out in the Press at the time.)

As soon as these matters are better understood, the fear that going off gold will lead to wild inflation (of the 1920 type) will gradually subside throughout Europe, and the only sensible thing will be done—namely, to devalue or abandon gold, to reflate gently on paper, and eventually to stabilise internal prices when they have recovered to about the undeflated cost level. In the meantime such countries should submit voluntarily to fluctuating exchange rates, as England is doing, which alone are economically healthy, and without which, as we shall show in Chapter XXII, recovery in Central Europe is almost impossible.

4. *Is Devaluation dishonest?*

Another common argument against devaluation is the important question of political honesty.

The breaking of all promises to pay is dishonest, but there would appear to be a certain moral difference between breaking a promise which you cannot help breaking and breaking a promise when default is avoidable.

Take the case of England in 1931. Prior to the abandonment of gold on the 21st September, devaluation had been advocated by many sections of the community on the ground that it would check the slump and set revival in motion. The great majority of Englishmen, however, were at that time agreed that any *voluntary* devaluation of sterling would be rightly considered as dishonest (since a pound note was supposed to possess implied conversion rights into gold at par) both to foreigners and to the internal population. Indeed, rather than incur the stigma of voluntary default England borrowed £130 million abroad in the hope of staving off such action.

The result, however, was that foreign speculators, seeing the pound in difficulties and seeing that devaluation was eventually highly probable, sold bears of sterling, *i.e.* borrowed sterling to buy gold francs and gold dollars, with a risk of not more than 2 per cent. and a chance of gain of 30 per cent. Indeed the speculative fraternity, seeing their chance, rapidly absorbed a large part of the newly-borrowed £130 million. Being right in their anticipations, they hastened on the collapse of sterling, and incidentally made a profit of over £30 million, all at the expense of the British taxpayer.

It might appear dishonest of England to break any of her implied currency promises, but it was to her honour that she did her best not to break faith with the foreigner or with her own nationals.

In the currency sphere, however, there are two quite different forms of defalcation and breach of trust. The first is not to pay *in gold* when an implied promise has been made to pay in gold; the second is to alter the internal purchasing power of money, either upwards or downwards, when the public expect it (and the burden of taxation) to remain unchanged. Indeed, so far as practical affairs are concerned, it is just as

dishonest of a government to alter the purchasing power of each unit of its currency, *i.e.* its convertibility into goods, as to alter the weight of gold metal behind each unit, *i.e.* its convertibility into metal. The problem of government dishonesty may, therefore, resolve itself into a dilemma, in respect of which the government itself is forced to choose between devaluation and deflation.

In the minds of many, however, to deflate, *i.e.* to put more value into money, is highly honourable, whereas to inflate or to devaluate is dishonest. But in fact the two actions are equally dishonest and inequitable.

Fundamentally, I suppose, it is the duty of a government to be " straight " with *all* its people *all* the time; but if being straight with one group involves being crooked with others, I am none too sure that it does not become the positive duty of the government to adopt whichever of the two " dishonest " policies it *honestly* supposes is the best for the nation as a whole.

Personally I do not regard myself as competent to judge on these ethical questions *in extenso*; but I certainly regard it as one of the " moral " duties of a government to supply its nationals with a stable internal money of account, and if the performance of this particular duty inevitably involves the non-performance of another, I presume it must be left to the government to decide which of the two performances—call them either duties or crimes—will be most beneficial to the nation *as a whole.* It is a question of choosing the lesser evil.

A government can, of course, easily arrange (if it wants to) that it shall lose all its gold before it devalues, so that on the surface it will appear to have been " involuntarily " forced into gold abandonment; but personally I prefer a more straightforward and less artful method without bothering to resort to pettifogging subterfuges aimed at giving what is really a " planned " devaluation a more ethical outward appearance.

I feel unfortunately that there must be a good deal of " twisting " in this form of argument, as inevitably there must be in all dilemmas upon which actual decisions have to be taken;

but, without supporting the argument that necessity knows no law, if it so happens that *past* governments have framed currency laws which, owing either to Fate or to the actions of other nations, are causing utter economic disaster to a country, it may possibly be the positive duty of a government deliberately to sanction the breaking of old contracts.

Moreover, since the abandonment of the gold standard is equivalent to the imposition of a tax upon certain classes of people; and since all governments preserve the right to impose specific taxes; the general practical view is that national necessity justifies the re-framing of laws concerning contracts. Hence if a government regards it as "a national benefit" to revoke certain old laws which are doing more harm than good, it is the duty of the government to act, even though some classes will be hurt, without receiving full compensation.

Finally, if the view is taken that although voluntary devaluation is inequitable, it will *sooner or later* become inevitable, since deflation *must* eventually reach a breaking point, a policy of "sooner" may be rightly preferred to a policy of "later," so as to avoid the interim period of deepening depression. Despite the admitted unfairness of devaluation, the few may rightly be deliberately sacrificed to the many for the good of the State.

Putting the matter in a nutshell:—Non-devaluation demands deflation; but deflation is a State method of upsetting the value of contracts, which is dishonest. The only alternative is devaluation, which is also dishonest for the same reasons. Result = dilemma. Therefore choose the evil which is least bad for the State.

CHAPTER XV

THE PRACTICAL CASE AGAINST ABANDONING THE GOLD STANDARD

1. Popular objections to abandoning gold.
2. Dr. Einzig's view.
3. The illusory cost of writing down stocks.
4. Effect on gold-producing nations.
5. The question of a " war chest."
6. The eternal conflict between the older generation and the younger.
7. People have little faith in paper.
8. What proof does the hoarding of gold provide ?
9. What do the masses really believe ?
10. The merits of an international and an exportable standard.

1. *Popular Objections to abandoning Gold.*

Although a strong practical and theoretical case can be made out for abandoning gold, (*a*) on the ground that the gold standard is theoretically unsound and (*b*) because politicians will not work the gold standard properly, the fact remains that such arguments at present command little attention in political and banking circles ; and even those few who happen to agree with our argument are so afraid of the responsibility, and the imagined cost, of scrapping the gold standard, that in actual practice it is highly improbable that any statesman will dare openly to advocate the experiment for some years ; indeed, to the majority of people to-day, the deliberate scrapping of the gold standard hardly seems to come within the realm of practical politics. And this for the following reasons :

(i) Because the gold standard has some undoubted advantages.

(ii) Because of the ingrained (though, as we show in Appendix A, fallacious) belief that all currency must have a metallic backing, and that foreign trade will

come to a standstill if an international currency is not available.

(iii) Because gold is supposed (despite the disproof of history) to be a valuable check against paper currency inflations.

(iv) Because America, France and England hold huge hoards (G. £800 m., £600 m., and £190 m. respectively).

(v) Because the British Empire and America are the chief gold-producers (South Africa 50 per cent., Canada 13 per cent., Australia 3 per cent., U.S.A. 11 per cent., out of a total world production of 23,000,000 ounces or £100,000,000 at par), and the disappearance of this industry would cause much misery.

(vi) Because the vested interests of discount houses, international insurance companies, bankers and other powerful City elements require the maintenance of a system of fixed exchange rates.

(vii) Because few politicians possess the mental courage to run the risk of getting themselves labelled "unorthodox," or of making powerful enemies among vested interests as a result of a programme of change.

Despite these powerful influences, accidental and evolutionary, as distinct from deliberate and revolutionary, abandonment seems far from impossible, for gold currency may fortuitously slip out of use even though the declared policy of almost all the on-gold nations is to stay on gold, and of all the off-gold nations to get back to gold "as soon as possible."

It is, however, essential to consider with great care the case against gold abandonment as presented by the gold protagonists. First of all there is the practical case of the cost of abandonment. This at first sight would seem to be conclusive, since the *monetary* stock of gold in the world is equivalent to about £2,000,000,000, and it is generally believed that if gold is abandoned the gold-holding nations of the world will be by this much poorer, and that the losses will have to be borne by somebody. Actually

this is not so. Against the monetary gold holdings of the Central Banks and Treasuries paper notes have been issued; and these paper notes have a definite purchasing power of their own. See Appendix A.

It is true that if the gold *and* the paper notes were *both* destroyed, the people of the world would be by that much the poorer (in terms of money); but the error of double reckoning must be avoided. If the legal tender notes remain in existence, even though their convertibility into gold is withdrawn, the paper notes will still remain in circulation and have purchasing power (as shown in Appendix A); so that nobody will be any the poorer. Indeed, so far as the general public are concerned they would be no worse off if the gold which they now believe from statistical returns to be held in the vaults of the various Central Banks was secretly taken by the Governors of those banks and dumped at the bottom of the sea. Indeed—to use our imagination—it *may have* been done already without us having been told about it! We do not, of course, *believe* that this is so, but for all that most of us know it may *already* have happened; and if so, it has certainly made no difference to any of us.

Actually the only people who would suffer from a fall in the price of gold, such as would follow *general* abandonment, would be the people who own the *non-monetary* stock of gold and the people engaged in the gold-mining industry. The non-monetary stock of gold probably does not exceed £300,000,000, and there are only about half a million people in the world engaged in the gold-mining industry. The capital value of gold-mining shares throughout the world probably does not exceed £500,000,000.

So far as the Central Banks are concerned they certainly have gold entered up as part of their assets to balance their note issue liabilities; but without any cost to *anyone*, these balance sheet entries can be made good by other "equally useless" assets. The system is merely an accountancy device, which can be altered by government decree. But more of this later.

Let us first consider the trend of opinion current among the pro-gold group.

2. *Dr. Einzig's view.*

In the *Future of Gold*,* Dr. Einzig, who perhaps more than any other writer represents the present City of London view, argues that the demonetisation of gold would involve such enormous *technical* difficulties, as to make gold abandonment virtually impossible. He says on pp. 67–71 :

> " Advanced currency reformers may well denounce the public for its foolish preference for gold. Even if we were to admit that this preference is unscientific, unjustified and unreasonable, we ought to thank our lucky stars for the 'foolishness' of the public. It is of immense advantage to a country to possess a commodity which it can export to any other country at any time without difficulties. In given circumstances it is the possession of that 'scrap iron' of no social utility that staves off starvation.
>
> " We must not fall, however, into the common error of monetary specialists by allowing our wish to be the father to our thought. If we were to depend for our anticipation that the gold standard will be maintained on the hope that the world's statesmen will realise how useful the system is, the basis of our conclusion would be very uncertain indeed.
>
> " In examining the prospects of the price of gold, what matters is not what *should* happen with regard to the gold standard but what *will* happen. It is safe beyond doubt to take it for granted that the gold standard will never be universally abandoned. Those countries with large stocks of gold, such as France, Holland, Switzerland, etc., would not think of replacing the gold standard with a managed currency in which gold plays no part. Although the United States may modify the system considerably—possibly by the inclusion of silver, or by other devices—it is certain that she will not discard her gold stock. In this world the right thing is done very often for wrong reasons, the gold standard will be retained, not because a majority of people are convinced that it is to the interest of mankind to do so, but largely because those countries possessing large gold stocks will work in favour of its retention. As far as Great Britain is concerned, although the actual gold stocks in her possession are much smaller than those of France or the United States, vested interests working in favour of retaining the system are none the less strong. After all, the British Empire produces 70 per cent. of the world's current gold output.

* Macmillan & Co.

The Union of South Africa is the world's largest gold-producer, and Canada occupies second place. Gold-production is an important source of the national income of Australia, India, Rhodesia, British West Africa and other Crown Colonies. The gold hoards of India run into hundreds of millions of pounds; the value of unmined gold which sooner or later will be produced and sold amounts to milliards of pounds.

"In such circumstances it is strange that the attacks on the gold standard and the demand for its complete demolition should come from Great Britain, while countries with little or no gold production of their own cling to the gold standard in face of the British attacks. The British attitude towards the gold standard, therefore, amounts to an attempt to persuade our customers that one of our principal products is not worth buying. Even if gold were really as worthless as the opponents of the gold standard in Great Britain try to make out, surely it is not for us to put the buyers of gold wise about it. If they are foolish enough to supply the British Empire with real goods and services in return for the yellow metal, let them do so by all means.

"Strangest of all, the anti-gold campaign is conducted from quarters which have always claimed to be the supreme defenders of Imperial interests. Does Lord Beaverbrook think that, in being instrumental to the abolition of the gold standard—which is one of the objects pursued systematically by his group of newspapers—he would render a valuable service to the Union of South Africa, to his native land Canada, and other parts of the Empire? Or is he simply unaware of the importance of gold production in the economic systems of the various Dominions and Colonies? Apart altogether from the economic aspects of the problem, does he realise its political implications? If Great Britain were definitely to abandon the gold standard it would sever the most important link that ties the Union of South Africa to the British Empire. General Hertzog, who controls the present destinies of that Dominion, has no love for Great Britain. The reason why he changed his policy and concluded an alliance with General Smuts was because he realised the extent to which the destinies of the system of the gold standard and the prosperity of South African gold production are in the hands of Great Britain. Were we to abandon the gold standard, there would be nothing to prevent the Union from severing completely its association with the Empire. Nor would the anti-gold policy in any way help Great Britain's relations with Canada. As for India, a reduction in the value of its immense gold hoards would inflict severe hardship on the population; and economic depression breeds discontent with the existing régime. The reason why violent opposition to the British rule in India has abated during the last three years is that economic conditions have improved; and one of the main factors in this improvement has been the rise in the price of gold. Thus, were Lord Beaverbrook's anti-

gold campaign to be successful, it would not only destroy a large portion of the wealth of the Empire but would encourage in more than one direction the disruptive forces which are at work.

"Fortunately for the British Empire, for mankind as a whole and, not least, for Lord Beaverbrook himself, there is not the remotest chance of his anti-Empire crusade succeeding. It is the declared policy of the National Government ultimately to restore the gold standard. The fact that the gold reserve of the Bank of England has been increased substantially and that the Exchange Equalisation Account is endeavouring to accumulate a substantial gold stock of its own is sufficient to indicate the trend of British official policy. Nor is there any likelihood of a fundamental change in this respect under a Labour Government. While a great deal is being said at present in Socialist quarters against the gold standard, once the Labour Party assumed the responsibility of office, its attitude on the question of principle would not differ materially from that of the present Government. Indeed, Great Britain could no more afford to abolish the monetary use of gold than she could the use of coal or of Lancashire textile products. Those Englishmen who advocate the definite abolition of the gold standard are cutting the tree under themselves, just as they would do if they were foolish enough to advocate the use of oil instead of coal, or the purchase of Japanese textiles instead of British.

"Apart altogether from considerations of vested interest, the technical difficulties of demonetising gold would in themselves be sufficient to discourage any inclination on the part of Governments to make such a decision. When, during the last quarter of the nineteenth century, silver was demonetised by a large number of countries, it was a relatively simple matter. All they had to do was to sell silver and buy gold. It would be interesting to know against what the opponents of the gold standard would propose to sell the accumulated gold stocks."

But here Dr. Einzig is making an abundant use of red herrings. He might like to knit South Africa to England by keeping on gold; but the British population, of whom two million are unemployed, would probably prefer not to be knitted to (unfriendly?) South Africa if the knitting entails continued depression for the sake of prosperity on the Rand, which only employs one-quarter of a million workers, of which only 25,000 are white.*

* The total population of the Union is 8,250,000, of which 1,800,000 are white.

No doubt it is easy to jibe at Lord Beaverbrook for his "anti-Empire" crusade, but, for all I know, Lord Beaverbrook may be taking a much wider and more statesmanlike view of the whole money problem than Dr. Einzig. Dr. Einzig may see across the one square mile of the City. Lord Beaverbrook may be looking right across not only England but also the whole of the world, with perhaps a more loving eye on England than Johannesburg.

Moreover, Dr. Einzig does not seem to realise that the actual cost to a Central Bank or a government of writing down its gold reserves is illusory. It appears that he does not perfectly appreciate the technical nature of a Central Bank's currency accounts.

3. *The Illusory Cost of writing down Stocks.*

The "heavy cost" argument against the abandonment of the gold standard is as follows :—

'If gold fell to, say, 40*s.* an ounce the Bank of England would suffer an inventory "loss" of about £100 m. on its present holding of nearly £200 m. valued at 85*s.* per ounce.'

'Indeed, the writing down of the gold stocks now held by Central Banks would involve the nations concerned in such heavy losses, and would impair the solvency of the Central Banks so much (and with it the nation's confidence in the national note issue), as to be in practice unthinkable; consequently the gold standard can never be abandoned, and to suggest it is mere unpractical theorising.'

It is, however, a fact that neither the nation as a whole nor the Central Bank would lose anything of real practical importance by the depreciation of the Central Bank's gold stock, provided (as is the case in every civilised nation) that the Central Bank enjoys the co-operation of the government.

First of all as regards the maintenance of gold for use in *foreign* trade. If it is agreed—as perhaps it will be if the reader has the patience to read all three of our volumes—that

stabilised internal prices and freely fluctuating paper exchanges are better for the nation as a whole than currencies pegged to gold, then the need for gold reserves for *foreign* trade purposes *ex hypothesi* disappears.

As regards the effect of gold abandonment on the internal purchasing power of the note currency : this is dealt with in Appendix A and even more fully in Volume I of this Series. I do not, therefore, propose to enlarge upon the matter in this chapter. The reader, however, who doubts my assertion should turn at once to Appendix A, returning later to the rest of this chapter.

Actually (as is shown in Appendix A) the internal value of a currency is determined on the one hand by the total supply (of notes and bank deposits), and on the other by real requirements —or the "demand"—of the public for currency. Thus the writing down or total elimination of the gold "behind" the currency, other things being equal, will not affect the *internal* purchasing power or efficiency of money at all.

Neither the nation as a whole, nor any individual within the nation, suffers a net loss ; for neither the external nor internal purchasing power of its currency is affected by a depreciation of the Central Bank's holding.

There remains the question of the Central Bank's balance sheet and "nominal" solvency. Yet here again the loss is illusory. The gold which figures on the right-hand or asset side of a Central Bank's balance sheet and balances its liabilities (in the form of notes and deposits) on the debit side is of importance only because the required ratio of gold to liabilities (or alternatively, the size of the fiduciary issue) is rigidly fixed by *government* decree. Thus, all that is required in order that the Central Bank shall remain legally solvent in terms of its accountancy figures, if its gold depreciates, is for the government either to increase the maximum fiduciary issue, *or* to lower the minimum legal reserve ratio—so that a lesser value of gold balances the same amount of outstanding liabilities. Alternatively, the government might provide the Central Bank with

some other purely " nominal " asset, which it could enter up in its books to balance outstanding notes, and thus offset the market depreciation in the value of the gold already held. This could be done by supplying the Central Bank with redeemable, though renewable, government bonds (perhaps non-interest bearing), to be entered in the Bank's balance sheet always at par, to replace the recently reduced market value of the equally non-interest-bearing gold.

In other words, the apparent loss to the Central Bank can be made good merely by an accountancy ruse which replaces, on paper, the lost value of the gold (buried in vaults and already inactive) by some other equally-inactive paper substitute, which will prove just as satisfactory a " nominal " backing to the note issue on the right-hand side of the Central Bank's accounts.

Indeed, under a *paper* currency system the only object, other than an accountancy one, in having any backing at all is that the Bank may possess assets which can be resold to the public for money, so as to retire such money, if it should ever be desired to deflate the currency because internal prices were rising too fast.

But since it would never be necessary to retire the *whole* of the currency for deflationary purposes, it would suffice if only part (say half) of the nominal backing to the note issue was of a resaleable nature, *e.g.* in the form of marketable government securities. The other " nominal " half could be composed of anything, even if it was entirely unsaleable—for instance, a photograph of bullion instead of bullion itself! From this it follows that if the existing gold backing to the note issue did at any time depreciate 50 per cent. in value, it would not matter to the currency authorities entrusted with keeping the internal purchasing power of money stable, for they would still be able to operate in the market, in order to control the volume of notes in active circulation, with such government securities as were still held by the note-issuing Central Bank.*

Indeed, any country abandoning the gold standard might deem it desirable from a practical point of view, unless it was

* This subject of controlling the currency is dealt with in full in Volume I.

thought wise to hold some gold as a war chest, to ship existing holdings to, say, America in settlement of debt while the American government was still willing to accept them.

* * *

4. *Effect on Gold-Producing Nations.*

Let us now consider the effect of gold abandonment on gold-producing countries, such as South Africa, West Africa, Australia and Canada. It is often argued that even though non-gold-producing countries might abandon gold, a British government could never adopt such a policy owing to the damage it would do to its gold-producing dominions and dependencies.

Certainly the disappearance of gold as currency throughout the world would be disastrous for all gold-miners; but since there are only a quarter million people employed on the Rand, *i.e.* only one-eighth of the recent unemployed in England,* consideration for the South African miner should not check even England, let alone other countries, from pursuing any such policy if they had come to regard it after careful thought as likely to alleviate unemployment.

Gold could remain completely out of use, and although it might fall very rapidly in value, the only "real" losers or sufferers would be those interested in gold-mining. This may seem at first sight a far-fetched statement, but in truth the matter is really only one of Central Bank accountancy.

5. *The Question of a "War Chest."*

One argument frequently made in favour of retaining a gold currency is that in times of war it is highly desirable to have some reserve fund other than foreign investments, which can be used to purchase food, war materials, etc. And it is

* Incidentally the market value of the mines on the Rand on January 1st, 1935, was only about £200,000,000, whereas the prefs. and ordinaries of the Imperial Tobacco Company alone stood at over £280,000,000. It would pay England herself to put the Rand "on the dole," if she could eliminate only a quarter of her own unemployment.

emphasised that this something should be valuable in proportion to its weight and therefore easily transportable by aeroplane.

This War Chest theory is doubtless quite sound. Indeed, if other countries remained on gold it might be highly desirable for even a paper-using country to hold a gold war chest. A paper-using country might therefore, after having deliberately abandoned gold, nevertheless still retain its existing gold reserve as a war chest, instead of immediately selling it to some still on-gold nation.

Actually, however, I am inclined to the belief—although I have not thought the point out very carefully—that a country threatened with a future war would do better to hold its war chest in the form of something likely to be useful in war-time, such as food, metals and munitions, rather than something like gold, which would have to be exported first before food and war materials could be obtained from abroad.

Indeed, for a food-importing country like England it would, I think, certainly be much better for the government to hold its war chest in the form of food rather than gold.

Even in peace-time there seems much to be said in favour of such a policy. It is known, of course, that sowing takes place in different parts of the world during every month of the year, and that if the crop in one area shows signs of failure, additional sowing takes place in others; so that there is very little danger of the world ever running short of food, even though the carry-over in grains is never sufficient to last more than a few months.

There are, however, many people who would feel happier if modern governments adopted the Joseph-like policy of national granaries in case there should ever be a series of successive bad harvests throughout the year in grain-producing countries. Such a disaster has never yet occurred—at least not in the last 400 years—but I presume that it is barometrically possible.

Be this as it may, the argument that a country should adhere to the gold standard solely for war chest purposes, even though it be admitted that the gold standard is on the whole less beneficial than paper, is so weak as to deserve little

attention except on the part of those who desire to confuse the issue by drawing red herrings across the trail. You can go off gold and yet retain gold as a war chest.

It might even be argued that gold should be exported at once, and the proceeds expended on the purchase of the bonds of foreign governments, which could be lodged in different foreign or colonial centres and sold when war broke out. These bonds would be interest-bearing in times of peace, whereas domestic gold reserves are not.

Even if gold is good as a war chest, it does not *per se* justify a nation in using gold currency itself.

6. *The Eternal Conflict between the Older Generation and the New.*

Although the statistical arguments against gold abandonment may be answered with some precision, the arguments based on mass psychology are more difficult to meet, although in my humble personal view they are no less unsound.

The test of a psychological theory is whether it works in practice. Our procedure, therefore, will be to recite the psychological theory as propounded by its most able exponents and then to make our qualifying comments.

* * *

Perhaps the chief fault of the psychological group is that, being men of much experience and of mature years, they make the habitual mistake of every generation, of not appreciating that after they reach the age of sixty there is a younger generation growing up, and already on the border-line of power, which has a different attitude of mind, owing perhaps to a different education and early experience of life.

Men's minds usually become crystallised somewhere in the early fifties, and the opinions acquired in their twenties and thirties become their fixed beliefs in their later years. It is therefore difficult for the older generation, brought up on the teachings of Adam Smith, John Stuart Mill and Bagehot, to realise that a younger generation actually has the effrontery to regard these noble pioneers as being rather ignorant and back-

ward in their subject, just as were the electricians of the 1890's compared with the electricians of to-day. One has, in fact, only to talk to certain Directors of the Bank of England, to certain members of the Cabinet, and to a great many of the heads of our greatest businesses, to be convinced that these successful, intelligent and much-respected gentlemen have not found time in the over-worked later years of their lives to keep in touch with the views of younger politicians, business-men and economists.

No doubt in its turn the present generation will become as crystallised as the over-sixty group are to-day; for this is in the nature of things. But even so it will be regrettable.

The older men, however, if they are honest, will admit that for the most part they make it a practice of *not* listening to the views of the younger generation, and are inclined to scoff at the new-fangled views of these young heretics.

Their juniors, of course, if properly brought up, know better than to argue with their elders who have twenty years' more experience of *life* (although perhaps twenty years' less of *modern* economic knowledge). But the older generation should not believe that because the younger men at dinner-parties or City luncheons do not "put the backs up" of their seniors, that nothing is going on within their heads. Far from it. A great many of these apparently affable young men are doing a mass of extremely hard thinking, preparing themselves perhaps to step into the honourable positions now occupied by their seniors. All these young men incidentally have had four years' experience of the army and know that no good is ever done to anyone by "disagreeing openly with one's general." And the general thinks that every promotion-seeking subaltern holds his own views. Blind general.

But enough of this theoretical peroration. Let us return to the psychological theories of the older generation, and examine to what extent they hold good in practice. Their views may have been true "laws" of psychology in the pre-war era; but they may no longer be true of the world masses to-day.

7. *People have little Faith in Paper.*

In an interesting Supplement to the *Economist* (of which Sir Henry Strakosch, G.B.E., is Chairman) of January 5th, 1935, Sir Henry, who is also Chairman of the Union Corporation, one of the leading groups of gold mines in South Africa, examined the case for a return to the gold standard. In the course of his argument he stated that an eminent banker once said, " If nine people out of ten believe that the gold standard is the best monetary mechanism, then it is the best monetary mechanism." " Human affairs," he added, " are governed far more by emotions, beliefs, traditions and prejudices than by logic and reason, and this applies particularly to monetary affairs." And further : " One of the most remarkable phenomena of the present depression is the implicit faith which people the world over have shown in gold as a safe refuge for their cash resources from currencies whose convertibility into gold seemed in doubt into currencies the convertibility of which was believed to be more assured ; and, when the number of the latter dwindled, into gold itself. There has never been any reluctance to accept gold in settlement of debts whatever the circumstances might be, or to regard it as the only possible basis for money. Whole nations, in the present depression, have undergone untold privations for the sake of maintaining the link between their currencies and gold. It would be foolish not to give the fullest weight to this firmly established psychological fact."

In *The Future of Gold* Dr. Einzig expresses a similar view. He asserts emphatically that " since the people of the world have a deep-seated (though perhaps foolish) preference for gold and always hoard it when other forms of currency are in danger, it is safe beyond doubt to take it for granted that the gold standard will never be universally abandoned." Dr. Einzig, claiming to be practical, prefers his readers to consider " not what ought to happen but what will." *

* Page 67.

From this premise he argues that even if all nations suspend the gold standard for a while there will actually be a sharp rise in the price of gold on account of speculative hoarding; since eventually the nations would return to gold, at rates which would raise the price of gold to a high level.

8. *What Proof does the Hoarding of Gold provide ?*

But is Dr. Einzig right (*a*) about his hoarding theory and (*b*) about an eventual return to gold currency? I doubt it.

The reason why the public (perhaps one-half or one per cent. of them, at the most) have hoarded gold in the past is: (*a*) because they distrusted their banks, (*b*) because they were afraid of their own paper currencies and (*c*) because there was always some other country still on the gold standard, which was willing to buy gold at the statutory mint price. Take away the statutory mint price for gold in all countries, and hoarding will (I think) disappear, because hoarders would have no one upon whom to unload their supplies except other hoarders.

Moreover, to argue, as does Sir Henry Strakosch, that the (wise) hoarding of gold (by a few rich men, not the general public) during the *recent* era of world currency confusion *proves* the existence of a widespread popular belief that gold is the best form of currency, is to jump to a conclusion which may indeed fit his argument, but which may not be sound. It might equally well be argued that this particular wave of hoarding reflected, *not* the belief that gold was in theory and practice the "*best form*" of currency, far from it,* but the belief of these thoughtful capitalists that gold was the best currency "*to hoard*" at the moment. I maintain that if there had not been some important countries still on gold, this preference for gold would not have existed and nervous capitalists would have invested in either commodities or equities, or in the paper currency of the country *least* likely to inflate.

* To believe that a thing is a good speculation (*e.g.* certain motor shares) is not to believe that they purvey the best make of car.

9. *What do the Masses really believe ?*

As for those English writers who suggest that German, Swiss, French, Italian and Belgian workers would be up in arms if their governments took them permanently off the gold standard : let them travel these countries at the present day and discuss these questions with shopkeepers, workmen, artisans and farmers, and they will soon find that this continued hunger and respect for gold is merely a figment of their own imaginations and in no wise approaches present-day reality. And this applies as much to France as to any other gold-using nation.

It is, of course, often stated in the French Press that the French peasant, after having had his savings wiped out by the post-war inflation, will in future never submit to any other currency but gold. It is also thought that French peasants are hoarding vast amounts of gold, which would make gold abandonment politically disastrous. Statistics of French gold imports and French gold holdings, however, do not confirm this view. Indeed, it is difficult to prove that the average French family is hoarding as much as a fortnight's income in the form of actual gold. The constant repetition of a fallacy—namely, that nearly every French peasant is hoarding gold and objects to paper money (which is the only money he has seen for twenty years)—does not make the statement any the truer.

I admit, of course, that there *was* a phase *before* the recent world slump, and *before* sterling was divorced from gold, when the French public believed that gold abandonment was *always* accompanied by inflation ; indeed many people had come to believe that the abandonment of gold was actually the " cause " of inflation. But, since then, public knowledge on this subject has become much more widespread ; and the French public are now aware that these arguments are unsound in theory and that they have also been disproved in practice. For they have seen twenty-two countries abandon gold in the last three years, without a single one of them suffering an uncontrolled inflation of the type which occurred in the early 1920's.

The Frenchman, it is true, may distrust his politicians, and may be afraid that they will inflate the currency, or do other silly things (like deflating the currency). But as it happens the politicians themselves now know that the best way to earn the hatred of the masses is to indulge in a wild paper inflation; and there seems no danger whatever of French politicians ever pursuing this course, even though they were forced to do so immediately after the War (since Germany did not pay) in order to rebuild the devastated areas.

Actually the class in France which is averse to-day, as distinct from before 1930, to France going off the gold bullion standard is not, I think, the peasants, who never see or handle bullion, but the international traders and bankers, and their political friends, and the gold shareholders (who *say* it is the peasants!).

Let those who are sceptical on this point concerning the beliefs of the voting masses consider the case of Germany. It used to be said, even as late as 1932, that Germany would never abandon gold because of her inflationary experiences in the early 1920's. But at this very moment Germany, with only £7,000,000 of gold left, is, with her numerous special exchange rates, actually in the process of slithering off gold. But who cares in Germany? Not a soul. I should like to take Sir Henry Strakosch from the Rhine to Berlin and give him an ounce of gold for every German he could find who was harmed by, or who regretted, the slither: he giving me an ounce of gold for every man who was pleased. Or Sir Henry might prefer a Land's End to John o' Groat's journey under the same conditions. In any case I should own, at the end of either journey, all the gold in Sir Henry's South African mines.

Incidentally, German internal trade and employment began to revive as soon as blocked marks began to be quoted at a discount; and virtually every German worker is delighted. There is, and has been, no currency panic whatever. Only good has come out of the slide. And if Germany soon lets her still overvalued exchange find its *proper* level so that she

earns more money with exports to pay for raw material imports, her revival will be even more speedy.

But enough of this figment that no French government would stand if it deliberately gave up gold. In fact, it would probably keep its majority for some years—a rare condition in French political life.*

Reverting to the alleged "deep-seated preference of the European public for gold" and the maxim that "if nine people out of ten believe the gold standard is the best monetary mechanism, then it is the best," let us ask ourselves: Do the supporters of this psychological theory really believe that anyone in Europe under forty years of age (even in France) has ever seen or used any gold, or that anyone except a few elderly gentlemen, who very rarely go outside their own cloistered City circles, respect gold in the same way as their forefathers (who incidentally never had to think about it) are supposed to have done?

That portion of the modern generation which bothers to think about money knows quite well that the worship of gold is ridiculous, and believes that the fluctuating internal price levels and tariffs which are the corollary of the authentic gold standard have been one of the chief causes of our low profits and unemployment; whereas that part of the younger generation which does not think on the subject nevertheless has a vague feeling that the gold standard is something for which the public "have to undergo untold privations" (to quote Sir Henry Strakosch's own words), and that going off gold means good

* It is interesting to remember that the British National Government was formed in September 1931 to "Save the Pound" and to prevent "disastrous inflation such as would follow if sterling were to depreciate *externally*." Fortunately, however, the National Government was unable to save the pound at all: indeed, the reason for its popularity between 1932 and 1934 was partly because it accidentally lost the pound; and partly because seven months later it accidentally effected a reflation by rather unwittingly inflating the bank credit currency by 18 per cent., in order to convert £2,000 million of 5 per cent. War Loan on to a 3½ per cent. basis.

These unorthodox accidents, which were both against the originally declared policy of the government, were the chief reasons for Britain's 1931–34 revival,—although tariffs, of course, played a temporary part.

trade, whereas staying on gold means depression. Indeed, they regard the elderly gentlemen who want to use gold because it has been the accepted basis for currency for 2,000 years, as similar to the cavalry generals who wanted to use cavalry on the Somme presumably " because their forefathers had used it." The new generation instinctively and logically prefer tanks to horses, even though horses have had their merits proved, and also their defects, by 2,000 years of past history.

The test of a psychological theory is not the frequency with which it is repeated by elderly men of position, but whether or not it works in practice. Some 400 millions of people in the sterling group have already shown that the psychological theory of internal monetary collapse and political upheaval on gold-abandonment is ridiculous. And even Germany, which suffered the biggest inflation of all in the 1920's, is giving yet another illustration of the unsound psychological beliefs of certain aloof and cloistered financial circles. These gentlemen no doubt honestly believe that " nine people out of ten " think that gold (which they never see or handle) is better than paper. But do they not invent the nine to suit their own theories, which also coincide as a rule with their interests ?

If you ask the man in the street whether he thinks gold or paper is the best form of currency, his quick reply will be Gold. If you ask him why he makes this reply, he will say, " Well, all the *Experts* say it is." If you ask him if the paper which he is using is doing him any harm, he will say No. And if you ask him if he would like the country to go back to gold, he will say, " No, I don't think so ; things were pretty bad after 1925 and the gold standard theories do not seem to work out in practice, either by making internal trade good, or by increasing the volume of international trade."

This, I assert, is the " modern " psychology. Lip service, to start with, is regularly paid to Gold and to the views of the City experts ; but in half a minute, when a man has had time to think, he contradicts his initial statement, and admits that he really has a preference for paper. To say that nine people out

of ten are thinking in this way is, dare I say it, not an unfair estimate.

Go to Australia, Sweden, Birmingham or Japan, and ten out of ten would be a sounder estimate.

I agree that no politician can afford to legislate beyond the average mentality of his public; but let not the experts fail to realise what the average thoughts of the public are.

10. *The Merits of an International and an Exportable Standard.*

The chief remaining objections to abandoning the gold standard are based on its positive merits, as follows:

(1) That it provides a country with a "commodity which it can export to any other country at any time without difficulties," to quote Dr. Einzig.

(2) That it gives the public the impression that there is something of real value behind their currency. (This is the fallacious bullionists' theory of the value of money, as distinct from the correct supply and demand theory. These points are discussed in Appendix A.)

(3) That it is a system to which international trade and finance have become accustomed.

(4) That it keeps prices roughly the same the whole world over.

(5) And, above all, that it provides international traders and investors, on whose activities world development so largely depends, not only with a stable medium of exchange but also with an unchanging money of account, which they can use as a standard for their long-term debts, making and receiving future payments in a definite quantum of a definite commodity.

These points will come up for consideration in the course of the following two chapters.

CHAPTER XVI

THE CASE AGAINST PAPER (I. Domestic Objections)

1. A currency without a metallic backing will collapse.
2. By destroying confidence in the price level, paper will upset internal trade.
3. Paper involves human control.
4. Paper encourages unsound government finance.
5. Paper leads to political corruption.
6. Paper has always been accompanied by inflation.
7. Paper concentrates the burden of the export–import corrector, which would prove less burdensome if more widely spread.
8. The geared effect of foreign trade.
9. Harmful internal effects of fluctuating exchanges.
10. Paper endangers the food supply.
11. Paper will reduce the financial earnings of the City.
12. Monetary theory is not yet sufficiently advanced for paper money to be managed successfully.
13. Difficulties presented by the use of index-numbers.

Usually when paper is being compared with gold, either a well-managed gold standard is compared with unmanaged paper, or well-managed paper is compared with ill-managed gold. Indeed I have rarely found a book (or a man) who presents both cases impartially.

Let us try to avoid this common fault, and attempt to state both cases fairly. I think, however, that the final verdict must be in favour of paper as against gold currency, for the horrors of paper are habitually exaggerated, while those of gold are habitually understated.

The case against paper is broadly as follows :

1. *A Currency without a Metallic Backing will collapse.*

That the public will not accept notes if these have no metallic backing, is an argument which is answered in Appendix

A and which (I think) is fully refuted on both theoretical and practical grounds in Volume I. Numerous instances, moreover, at this moment exist of a public not being allowed to cash its money for gold at all, and yet continuing to use inconvertible paper for the simple reasons that it is still legal tender and that they must have some form of money, since barter is impracticable. The twenty-two off-gold countries provide a proof of this particular contention.

2. *By destroying Confidence in the Price Level, Paper will upset Internal Trade.*

The second objection to paper money is that it destroys confidence. The usual argument runs as follows: Paper currency implies not only that the exchanges will fluctuate, which is upsetting to international trade, but also, in so far as paper has no internal gold backing, that no one will ever know what it is going to be worth. Hence the confidence, not only of foreign traders, but also of home traders, will be upset and the volume of internal business will diminish.

But although *unmanaged* paper must certainly destroy confidence, properly managed paper will probably promote it. In fact people who talk about paper money destroying confidence should take the trouble to differentiate between managed paper and unmanaged paper. They should also remember that in the past even gold has not been sufficiently stable to inspire *thoughtful* people with much business confidence. Gold prices have frequently moved upwards or downwards by over 20 per cent. within a few years.

Despite the present popularity of the argument, it appears rather pointless to argue that the adoption of managed paper would engender uncertainty and thus cause bad trade—internally as well as externally. Confidence, I think, would be increased by the knowledge that in future neither deflation nor inflation would be tolerated. This belief is impossible among *thoughtful* people if the country is on the authentic gold

standard, since this system definitely *requires* fluctuations in the general price level.

3. *Paper involves Human Control.*

A third objection raised against paper money is that it is not automatic and requires human control, thus giving scope for dishonesty.

Human control, however, is exercised even under gold, for under the gold standard the quantity of credit and notes is deliberately manipulated so as to keep the exchanges stable, whereas under controlled paper it would merely be manipulated so as to keep the index of commodity prices stable. The actual technique is exactly the same, and only the objective aimed at is different.

Moreover, even on a reconstructed gold standard, as advocated by numerous writers to-day, there would have to be a large element of human control (of an *international* nature), as the advocates of gold themselves admit.

4. *Paper encourages Unsound Government Finance.*

A fourth objection to paper money, as opposed to gold, is that whereas gold is a check on reckless government finance, paper allows spendthrift governments to print more money whenever they run into debt. In reality, however, this argument is not an argument against paper any more than it is an argument against gold.

Firstly, Cabinet Ministers are not *normally* so irresponsible that, just because their currencies happen to be on paper, they say to each other, " Here is a chance of winning public favour by reduced taxation or increased public benefits. Let us therefore inflate." Whereas, secondly, if an irresponsible and reckless government does ever happen to get into power and run into debt, it never hesitates, even under the gold standard, to abandon gold and print paper money. History supplies a long series of instances where even gold has not been an effective check at all.

I should here add that the currency account of a nation should be run, not by its Minister of Finance, but by its Board of Trade or Department for Commerce. The currency account and the budget account should be separated, and should be under the control of *different* ministers.

5. *Paper leads to Political Corruption.*

A fifth objection to managed paper is that an increase or a decrease in the supply of money benefits different classes and industries in different degrees. Sectional interests will therefore lobby (and try to bribe) politicians in order to further their own vested interests.

I do not deny it. But lobbying already goes on all the time as regards tariffs and taxes. Is it therefore legitimate to argue that taxes and tariffs should be eliminated? Obviously not. There will be lobbying, I agree, under paper, just as the gold group lobby politicians at present. But not all Cabinet ministers or Civil servants are corruptible, and they soon get used to sectional lobbying. It amuses them. And most of them (in England) are really quite incorruptible.

Indeed, should capitalism perish because of its unsound money, an appropriate epitaph would be: "They refused to reform for fear of corruption."

6. *Inflation has always taken place on a Paper Standard.*

The next argument is the most hackneyed and ridiculous of all, namely, that whenever paper has ousted gold there has always been an immediate inflation. Indeed, it is pointed out that until England went off gold in 1931 history showed that the abandonment of gold was almost invariably *accompanied* by violent inflation.

But this does not prove that the abandonment of gold has been the *cause* of inflation. On the contrary, it is unchecked inflation that has driven countries off gold, rather than gold abandonment which has *caused* unchecked inflation. The foolishness of this confusion of cause and effect is, however,

one of the most remarkable features of current economic controversy.*

It is obviously true that uncontrolled inflation for budget balancing purposes is entirely bad, and certainly this is what has *usually* happened before (and also after) countries have gone off gold in the past; with the result that going off gold has always been *accompanied* by inflation, although it has *not* been the cause of it. The abandonment of the gold standard has, in fact (until England went off gold), always been the sign and effect of prior *or* anticipated inflation.

In actual fact, if a government is willing to balance its budget properly there is no need whatever for paper currency ever to get out of control (see Volume I), merely because the country is not on gold. I pointed this out in my *The Coming (English) Boom* two days after England went off gold on September 21st, 1931. I was rather widely reprimanded in the Press at the time, but my argument has not yet been invalidated.

The truth is that if the currency authority does not print paper money for government purposes, it can continue to issue paper solely in relation to the index of prices. The result will be that budgets will probably become stronger if trade is kept at a high and healthy level by a policy of reasonably well-controlled paper. (Compare England from 1931 to 1934.)

To say that because inflation has usually *accompanied* gold abandonment, that therefore gold abandonment has always been the *cause* of inflation, is to confuse both the time-factor, and cause and effect; and yet one hears this ridiculous argument almost daily. (The editors of mining columns in the Press are without doubt the worst offenders.)

7. *Paper concentrates the Burden of the Export/Import Corrector, which would prove less Burdensome if more widely spread.*

Another argument against those who advocate a paper standard is that " their contentions are based primarily on an

* And even more startling still is the tendency to label all advocates of paper as inflationists of the post-war German type.

assumption of the unimportance of international trade and investment, and on the consequent conviction that it is better for international trade to strain at a camel, than for home trade to have to swallow a gnat" (I quote a leader in the *Financial News* of the 14th December, 1934, attacking me for the view I had expressed in a series of articles in that Paper just previously).

Personally I take up the position that it is the Editor of the *Financial News* who is mistaking a gnat for a camel. Let us put his personal views in the microscope.

If, owing to an adverse international balance arising out of fortuitous imports, or fortuitous foreign loans, or fortuitous movements of short-term capital, a country loses a large portion of its gold reserves so that bank credit has to be deflated internally, internal economic confidence is immediately upset. Consequently—as Dr. Einzig of the same Paper admits—100,000 men are often put out of employment as a result of the attempts to correct the international equation, by the normal blunderbuss process of making almost *all* internal prices decline, and business profits with them, merely so that in the end a few export prices may be lowered. In such a case what the *Financial News* is pleased to regard as a gnat begins (I think) to assume the proportions of a camel. And I think that the unemployed, and equity shareholders, will agree with me.*

I therefore adhere to my point that it is not only fairer, but also more intelligent that the burden of the international corrector should fall on the foreign exchange market itself—where it rightly belongs—than on the whole community, where its influence is unnecessarily "geared up," and not only more disturbing but also more unjust and less efficacious.

Personally, however, I very much doubt if the Editor of the *Financial News* was aware, at the time of his article, of this "geared-up" defect in the gold standard.

* The economic interests of the ordinary shareholder and the *un*-employed are much in common, although as soon as a man gets in a job, his former ally becomes his natural enemy in the intra-company fight for fair shares in the "product of industry."

8. *The Geared Effect of Foreign Trade.*

And when the *Financial News* goes on, in the same article, to argue that " a decline in the relatively small section of world business which is international has an unduly *disproportionate* effect on the total volume of business, owing to depression in the export industries, just like depression in any other specialised direction, setting up a series of maladjustments and *secondary* repercussions, which can prevent any semblance of prosperity in business as a whole," the writer is falling into the popular fallacy of Geared Repercussion which will be exploded in Volume III of this Series.*

I agree that a dislocation in *any* industry, *if* it upsets *general* confidence, may cause a *general* contraction of credit, thus having *geared* repercussions; but these geared results *only* mature (as we show in Chapter XV of Volume III) if *general* confidence is disturbed. And general confidence is certainly *more* upset by a *general* banking squeeze, such as *habitually* results under the gold standard when bank reserves are fortuitously drained abroad, than it is by the fact that one or two international traders and financiers make lower profits for a few months because they have not covered their foreign exchange commitments fortunately under paper.

The theory of a " geared " repercussion is only true if a decline in one industry upsets *general* confidence in others, and

* Namely, that, as under barter, so under money, a decline in one industry (owing to its selling less) does *not* influence others unless general confidence is also upset. To argue, as many people do (although it seems sound at *first* sight), that if one industry sells less, its own members will buy less from others; and that if they buy less, some other industry will also sell less, and so on unto seventy times seven, in a geared-up manner, is to forget that if the first industry fails to sell something which it *might* have sold, its potential customers will then be able to spend their money on the products of one of the *other* seventy industries instead. If the *Financial News* theory were true, the refusal of a passenger to tip a Taximan sixpence instead of threepence would, after a while, cause a slump throughout the whole of English industry. But the *Financial News* fallacy, although common, is too lengthy to discuss in this particular book: it is dealt with fully in Volume III. And in any case one cannot in a chapter of this size rewrite the whole of the *Principles of Economics* to demonstrate the errors of one leading article.

causes money to be hoarded and/or bank credit to be contracted. The gold standard automatically requires *general* monetary contraction which affects *all* industries; therefore, under gold, the repercussion is *always* automatically geared, whereas under paper it is not.

Thus the *Financial News* falls into the dual mistake (i) of not understanding the simple theory of Economic Repercussion, and (ii) of not observing the gearing which automatically takes place under gold. And yet they are very free with their obloquy.

* * *

Returning, however, to our main point, namely, that it is better for the burden of the international "corrector" to be spread rather than concentrated. Much might be said for this contention *if* the diffusion were small and imperceptible and *if* it were not positively magnified. But in actual fact it is grossly magnified. In consequence of this magnification the whole of the debtor/creditor relationships, the profits, and the volume of employment of the whole community are upset, in the hope that sooner or later the change in the *general* internal price level will cause a *few* extra goods to be exported, on account, say, of a 5 or 10 per cent. fall in their prices, such as will result from the *general* price deflation.

Indeed, a policy based on changing the internal prices of almost *everything* by 5 or 10 per cent., and thus cutting a great many profits to the bone, in order to secure a 5 or 10 per cent. change in a *few* export prices, is a "magnified" folly which it is regrettable to see so many influential pro-capitalists defending.

It seems to me that what the *Financial News* and other authorities ought to notice is not the *imaginary* geared disturbance of the paper exchanges, but the actual geared disturbance which *invariably* takes place under the gold standard when it is necessary to lower a few export prices. But those who advocate the gold standard not only put their telescopes to their blind eyes, but also, when they *do* deign to use the

right eye, accidentally (or is it deliberately) employ the wrong end of the telescope.*

In the meantime they dub one a swallower of camels and a rather dangerous unorthodox "revolutionary." But at present the blind are leading the blind, and that is perhaps why the world is in difficulties.

9. *Harmful Internal Effects of Fluctuating Exchanges.*

A ninth objection to paper money, with its corollary of fluctuating exchanges, is that the latter, by causing uncertainty, check not only external but internal business. For instance, productive enterprise and forward orders in home trade may be checked because it is feared that a sudden slump in some foreign currency may cause unexpected undercutting next day from abroad.

This is true, but the argument works both ways; the value of foreign currencies will often improve and actually *reduce* undercutting, thus stimulating both home and foreign trade and generally improving domestic confidence.

Moreover, since the only alternative to fluctuating exchanges is a fluctuating internal price level, and since all price movements must be annoying to someone, it is much better that foreign currency should fluctuate according to the law of demand and supply, as theoretically it should, and influence, for the most part, *only* the foreign trading community, than that the whole community should be deprived of the advantage of stable money.

In any case, the importance of foreign, as opposed to domestic, trade is considerably overrated. It accounts for only about one-quarter of the total national production in Great Britain, and less than 10 per cent. in America. It is, in fact, wrong to say that England is "mainly" dependent on her foreign trade for her industrial prosperity.

* This Editor always hits me hard. In public we send each other serpents; in private, doves.

10. *Paper endangers the Food Supply.*

This brings us to the tenth common objection to paper, namely, that since fluctuating exchanges hamper foreign trade (*sic*), and since certain countries, particularly England, depend on their export trade to secure their foreign food, nothing must be done in the currency sphere that could possibly hinder foreign trade. A gold currency, they say, is essential to England so long as she depends for her life on foreign food.

This argument, though common, is nonsense, and displays a lamentable ignorance of both the theory and practice of foreign trade.

For example, if England has not already earned with her exports sufficient foreign currency to pay for the food-imports she requires, the attempt by English importers to buy foreign money in the foreign exchange market with which to buy foreign food, will so force up its price owing to demand exceeding supply, that sterling will become internationally depressed, and foreign buying of British goods will be stimulated. The paper exchanges, in fact, will very rapidly engender whatever exports are required to pay for our imported food. The gold protagonists, however, see fit to frighten the public by saying that " if they do not have gold they will not have food."

It might here be added that the paper exchanges do not prevent, but actually facilitate, the settlement of foreign debts —both commercial and political. If one country owes another more (war debts, say) than it has earned with excess exports, as soon as the debtor government goes into the foreign exchange market and starts bidding for foreign currency, the price will rise, its exchanges will relapse and an excess of exports will be engendered. Provided that sufficient domestic funds are forthcoming to buy the foreign money, the international transfer of goods is automatically effected.

The merit of the paper exchanges is that they rapidly make

exports equate with imports (debts, of course, being similar to imports).

11. *Paper will reduce the Financial Earnings of the City.*

An eleventh objection to paper currency and fluctuating exchanges is that if we (in England) do not have fixed exchanges the earnings of London as a financial centre will diminish. "Every day," say the supporters of this theory, "that sterling remains a fluctuating and independent currency means a substantial loss to our invisible exports, such as financial and insurance services. Moreover, it leads to the atrophy of that magnificent financial machinery which we have built up in London to conduct a business to which stability of exchanges is the very breath of life. Since we are not only a great trading community but also a world financial centre, it is clearly in our interest to take the earliest opportunity of returning to gold." *

But here we merely have the inevitable clash between the vested interests of the International Group in the City on the one hand and those of the rest of the community on the other. Certain houses in the City (largely owned by foreigners or naturalised foreigners) will certainly suffer inconvenience from unstable exchanges, and the "magnificent machinery" may stagnate (although personally I think it will become more active. See Chapter XVIII). But even if this specialised business does wane, that, I suggest, is much better for England as a whole than that general stagnation should repeatedly occur among the *still more* magnificent machinery throughout the rest of the country.

It should be remembered, moreover, that, so long as tariffs continue to be positively called into existence by the gold standard, the decrease in the total volume of foreign trade will largely offset the advantages accruing to international traders and financiers from stable exchange rates. In a word, although the gold standard does give the advantage of fixed exchange

* I have unfortunately forgotten the name of this writer.

rates to the international financier, these advantages are likely to be *more than* offset by the aggregate shrinkage in his business which must result from the impediments placed on the international flow of goods. Paper exchanges will in the long run probably increase, not diminish, the earnings of the City.

12. *Monetary Theory is not yet sufficiently Advanced for Paper Money to be Managed Successfully.*

Another objection to paper is that " So long as we do not agree more clearly about the most fundamental problems of monetary theory we are not as yet in a position drastically to reconstruct our monetary system; nor in particular to replace the existing semi-automatic gold standard by a more or less arbitrarily managed currency. Indeed, in the present state of knowledge the risks connected with such an attempt are much greater than the harm which is possibly done by the gold standard." * Managed paper, it is said, may raise more problems than it actually solves.

This artful humility is most disarming. But let us pause for a moment. Is it humility? The gold enthusiasts may, perhaps rightly, regard themselves as possessing insufficient knowledge of the theory of money to work a paper currency correctly; but I am afraid that a great many of us paper enthusiasts are by no means so humble. It is not claimed by the paper party that they already know *all* there is ever to be learnt about money, or about the art of controlling the business cycle, or reducing unemployment. But we do claim: (*a*) to be able to lay our fingers on the various causes of spasmodic and cyclical depression (see Volume III), and (*b*) to be able to counteract the *majority* of them by means of intelligent monetary management. And we are not afraid to say How, in detail! (see Volume I). We deny, in fact, that paper money must get out of control; and we assert that it can be managed sanely and used to keep the price and profit level stable, without getting out of control, just as the internal bank deposit currency was

* I have unfortunately mislaid the name of this writer too.

used before the War, or rather between 1925 and 1931, to make prices fluctuate in accordance with the needs of the gold standard. In other words, although the gold enthusiasts make out that they do not know enough about paper to use it scientifically, the paper group admit no such ignorance.

All that this particular objection to paper amounts to is to say that until there is "unanimity" of opinion, no reforms should ever be adopted! This, of course, is a feeble argument and reminds one of the early days of the petrol motor, of Daylight Saving, and of numerous other reforms to which persons possessing "orthodox" minds objected on the grounds that they were new-fangled and *therefore* much too dangerous.

For my own part, I would not for one moment go to the opposite extreme and say that all new-fangled suggestions must *ipso facto* be sound. Moreover, I admit that no lengthy historical example can as yet be adduced to show that managed paper money will work perfectly smoothly in practice, even though Sweden has for the last three years, despite the world crisis, kept her prices within a 2 per cent. deviation.

I do, however, submit that if under the old gold system paper notes and bank credit were manipulated effectively so as to keep the foreign exchanges stable, it seems to follow that they can be equally well manipulated so as to keep an index of prices stable to within a few points. The actual process is exactly the same; only the objective aimed at being different.

13. *Difficulties presented by the Use of Index-Numbers.*

Another *possible* argument against paper arises in view of the fact that most paper enthusiasts (rightly) wish to alter the supply of internal currency according to variations in the index of internal prices. Objections to this principle might be raised (although they have not been yet, so far as I am aware) on the ground that if a wave of political nervousness swept the country, there might be a flight of capital, or withdrawal of foreign funds, with the result that the paper exchanges depreciated. Some internationally arbitraged commodity prices would there-

upon immediately rise; and since the index would rise, the Currency Controller would immediately begin to deflate and thus destroy domestic prosperity at a time when there was a tendency for it *also* to be destroyed by hoarding of money due to the political wave of fear. In other words, paper would be just as bad for internal trade as gold (when gold was exported) —so that paper is therefore not worth adopting, since it has not the merits of the economic stability which the paper-men claim.

Such an argument *would* be sound if the Currency Controller was made into an absolute automaton and not allowed to "weight" his action according as exchange fluctuations alone were clearly making his index move. But, as I shall show in Volume I, a more sensible use of index-numbers can be adopted; there is no need for a paper system to be managed *idiotically*, as some gold protagonists see fit to suggest. These matters can really be legislated for quite intelligently; just as seasonal drains of gold were *intelligently* allowed for before the War.*

It is, of course, often stated that there are no examples of a paper standard which has not *ultimately* suffered severe depreciation, and it is natural that people should hesitate to entrust the standard of value to government officials and central banking authorities in view of the ignorance and folly they have sometimes manifested in their past performances; but, as Dr. Gayer has pointed out, the possibilities of paper currencies cannot be fairly evaluated on the basis of *past* experiences with them when they have always been adopted *involuntarily* under the stress of acute crisis and emergency which has *already* broken the gold standard. Furthermore, says Dr. Gayer, and most of the protagonists of gold agree with him, "whether we like it or not, the monetary standard of the future, even if based on gold, is bound to be an increasingly managed one under which the policy of central banks will as much determine, as be determined by, the value of gold."

* Volumes I and III will contain my suggestions concerning the technique of issue and withdrawal, and the right use of indices.

All money has to be managed either to protect the gold reserve or to keep the index stable. The process of credit control is exactly the same; and even the gold party know quite a lot about it.

Certainly when people knew virtually nothing about the theory of money and the construction of index-numbers there was much to be said in favour of a semi-automatic international standard of value and an international medium of exchange, for such a standard not only allowed all prices and debts to be expressed in a common, though possibly unstable, medium: it implied an approximate integration of the price and income structure throughout the economic world; * and since the annual new production of gold was small in relation to the total quantity in existence, gold was the most suitable and soundest medium of exchange that could then be found.

But since the modern system of bank credit, and commercial credit,† has become more refined, and since in the modern world it is the fluctuations in bank credit and confidence which determine the purchasing power of gold (although certainly fluctuations in the volume of gold also influence the supply of bank credit), gold itself is not nearly as stable in value as it used to be. Moreover, since the younger generation now understand the theory of money, and the causes of price fluctuation not only in terms of the supply of money but also in terms of the store-of-value demand (which the older economists most certainly did not. See Appendix A), there is no need to continue using "a barbarous relic" which, in practice, causes so much poverty, unemployment and industrial fluctuation, just because a few rather stodgy-minded though well-meaning old gentlemen cannot quite grasp the significance of paper—or gold.‡

* Not that this does any good! See p. 169.

† See Volume I for the influence of fluctuations in Commercial Credit on trade and prices.

‡ Although I have made no attempt to avoid infuriating the unquestioning worshippers of gold, I hope I have refrained from either mis-stating their criticisms of paper or answering their idolatry with any unfair or fanatical "twist."

CHAPTER XVII

THE CASE AGAINST PAPER (II. International Objections.)

(Popular Arguments)

1. There must be an international currency if foreign trade is to survive.
2. The use of paper is a retrograde step and makes a world currency system more distant than ever.
3. Paper makes prices different in different countries.
4. Paper fosters dumping by (Eastern) countries with underpaid labour.
5. Tariffs are bred by paper as much as by gold.
6. Paper causes too much instability.
7. Paper exchanges are at the mercy of speculators.
8. Paper discourages international investment and world economic development.
9. Paper, by checking foreign trade, encourages economic nationalism.
10. Conclusion.

1. *There must be an International Currency if Foreign Trade is to Survive.*

A frequent argument against paper money is that foreign trade will decline and disappear unless there exists an international or exportable currency. This is sheer nonsense. Foreign trade in the off-gold sterling area to-day (1935) is already reviving despite high Tariffs, and despite—indeed because—several leading foreign exchanges are no longer rigidly pegged, but are healthily finding their true economic levels, and are fluctuating, as they should, according to the Laws of Supply and Demand within the foreign exchange market. Foreign Trade can be active without an international currency.

2. *The Use of Paper is a Retrograde Step and makes a World Currency System more distant than ever.*

Another argument against the adoption of paper is that such a policy would take the world one step further away from

an international banking system such as alone will enable all countries to have stable exchanges *and* stable internal prices. The use of an international gold standard, so it is said, is the first step towards an international banking system, therefore to abandon gold is a reactionary policy.

This argument would be sound if there were any prospect of the different nations abandoning their nationalism and submitting their internal monetary systems to the control of an international committee. As explained in Chapter I, however, this is so unlikely that the above particular argument against paper becomes of no importance.

3. *Paper makes Prices Different in Different Countries.*

Another objection to paper is that raised by Mr. W. F. Tuke, Chairman of Barclay's Bank, in his annual speech in January 1935. The " essential purpose " of the gold standard, so he said, is that it should " maintain equilibrium between the price levels of the various countries of the world." But what practical good does this do? None! Moreover in actual practice even the gold standard has never made " prices the same in all countries "; and even if they were the same, what good does it do anybody? International trade would still take place in those commodities whose costs, for geographical and other reasons, were different. Nor is there much difference between gold and paper on this score. Even under paper the final net external prices of most commodities are arbitraged out by traders, and become more or less the same in different countries *if* international trade is not interfered with.

Mr. Tuke's policy, it seems, merely expresses a desire to tie the price level of one's own country to the average of the world, regardless of whether the trend of world prices is inflationary or deflationary.

The point, I think, to realise is that the desideratum of sound money is not so much that it should keep prices the same in different *countries* (which is rather useless, since numer-

ous costs will still be different), but that it should keep prices stable *internally*.

Hence it is unsound to tie one's money rigidly to foreign monies unless they do *not* fluctuate in value. But Mr. Tuke did not deem this point even worthy of the briefest mention in his speech.

The Chairman of Barclay's Bank thinks, moreover, that there must be " a stable basis for international trading before it can be substantially increased "; but has he forgotten the even greater need for a stable basis for *internal* trading? Does he think that foreign trade is more important than domestic trade (when, in fact, it is not a quarter the size); or is he unaware that there must be some form of international " corrector "?

Or does Mr. Tuke merely repeat, without thinking deeply, the shibboleths which " go down well " at meetings in the City?

4. *A Paper Standard fosters Dumping by (Eastern) Countries with underpaid Labour.*

Another argument against paper is that if the exchanges are not pegged it will be impossible for the more civilised Western manufacturing nations to put on *effective* tariffs against the exports of Eastern countries produced with underpaid labour: with the result that Western labour will be undercut and unemployment increased, because of paper exchanges.

This argument, though popular, is entirely fallacious and is based on a misunderstanding of the export/import equation and of the causes and effects of fluctuations in the paper exchanges.

Actually if England were to return to the gold standard, and if Japan also returned, cheap Japanese labour now equipped with modern European and American machinery would lead to the flooding of Great Britain's domestic and foreign markets with cheap Japanese goods, produced with what we regard as

The result would be that our import surplus would grow and our export balance decline, so that gold would be progressively drained away from us and a continuous deflation of the British internal price level would be necessary in the hope of getting our costs of production down to those of our Asiatic competitors. We should, in fact, be subjected to an enforced deflation, lasting for many years, similar to that which we suffered when we returned to gold in 1925 at an over-valued rate of exchange compared, on a purchasing power parity or wage-cost basis, with that of France.

It is true that, in the long run, our loss of gold to the Far East would (or might) cause an inflation of costs and wages in Far Eastern countries (assuming them also to be on the gold standard, and assuming that they did not invest their export surplus abroad), so that *eventually* the wage undercutting would disappear. But since the expanding internal trade of Far Eastern countries will of itself require more gold as a backing for the expansion in the currency media, many years might elapse before there was any large inflation of the internal prices and costs of Japan. Meanwhile Great Britain would be subjected to a continuous and destructive Eastern competition.

On the other hand, if we and Japan remain on paper, any large export surplus on the part of Japan to England or elsewhere will cause a depreciation in sterling and a corresponding appreciation in the Yen; with the result that the net external advantage of underpaid Eastern labour will be wiped out by favourable movements in the foreign exchange market. The Japanese export surplus would thus of itself counteract, via exchange market movements, the real cheapness of Japanese goods produced with underpaid labour.

Such a correction would be inevitable (*a*) unless Japan reinvested her export surplus abroad, thus reducing the foreign demand for Japanese money; and (*b*) unless Japan for a while pursued a policy of internal currency inflation sufficient to keep her paper exchanges *continuously* undervalued "on prospects."

It is gold, not paper, which emphasises the bugbear of

5. Tariffs are bred by Paper as much as by Gold.

Although the primary function of the foreign exchanges is to keep the payment-balance in equilibrium and to make exports and imports balance, they should also facilitate international trade to the maximum so as to secure the utmost benefits from the international division of labour.

The question is, Do the paper exchanges do this; or do their fluctuations lead to tariffs and reduce the volume of international trade, as much as under gold?

We have already shown that gold tends to breed tariffs because ministries find it politically impossible to let the gold standard work properly according to its authentic rules. But does not paper breed tariffs equally? I doubt it.

Firstly, on a paper standard the exchanges do not fluctuate in one direction only, unless a country is progressively inflating —which is *not* the policy which we are discussing or advocating in this book.

Under a managed paper system the exchange quotation will move first above the true equilibrium and then below; so that *permanent* tariffs will not be necessary. Moreover, if one country does put on permanent tariffs against the goods of another, thus reducing the exports of the latter, the reduction in the latter's export-earned supply of foreign money will soon affect the exchange market and cause *permanent* depression in the paper exchanges, sufficient to nullify the tariff; so that exports will again begin to balance imports.

The country imposing the tariffs will thus either not be successful in shutting out exports at all, or will alternatively cause a diminution in its own exports too (see Chapter IV), because it indirectly checks (via exchange movements) the imports of the country against which its own new tariffs were imposed.

The result in the latter case will be that the export trade of the tariff-imposing country will be diminished; whereas in the former case the tariff will merely prove futile. Finance

ministers will soon become aware of this truth and of the futility of tariffs under paper, and paper will therefore not breed the high tariffs to which the gold standard gives rise.

Indeed one of the supreme advantages of a paper system is that it largely tends to make all tariff walls futile, by jumping them.

6. *Paper Causes more General Instability than Gold.*

The next question connected with the idea that paper diminishes a nation's prosperity is the vital question of aggregate disturbance. (*This is a difficult section.*)

The essence of the paper exchanges is that, if left to themselves, they will fluctuate not necessarily about the purchasing power parity, but about that exchange rate which is most calculated to bring the payment balance into equilibrium.

If either a gold quotation or a paper quotation is below this equilibrium rate it will certainly have the effect of stimulating exports, but it will simultaneously hinder imports; and if the export surplus continues for too long the exchanges will eventually swing in favour of the exporting country until its currency becomes over-valued (or, under gold, until the resultant gold influx forces up home prices and depresses prices abroad, so that a similar condition of over-valuation and diminution of exports matures).

The best results are, of course, obtained from the ideal equilibrium rate, rather than from a permanently fixed rate,* although if it were possible that the equilibrium rate could also be a permanently fixed rate, that would be ideal.

This, however, is not possible. Miscellaneous changes in international tastes and requirements, in speculation and in lending, and in the internal prices of goods traded internationally, are always altering the true equilibrium rate which would in a frictionless world equate exports and imports *for a while.*

The point is that a true equilibrium rate, even if tempor-

* See Chapter XI.

arily attained, is soon altered as a result of subsequent changes in international demands. No equilibrium rate can ever be permanent, unless internal prices are made to fluctuate, either under paper or gold.

Moreover, since it is impossible statistically to measure what the true equilibrium rate is, and since it can only be found by trial and error as a result of the exchange quotation fluctuating about an ever-moving mean equilibrium rate, it is probably better to let the exchanges fluctuate in this way and find their best economic *mean* level, rather than to institute a pegging process, at an arbitrarily selected fixed figure, by means of the gold standard.

To persons who have only glanced at the surface of the problems of the foreign balance it seems obvious that the foreign exchanges ought to be permanently pegged; but to those who have studied the problem carefully, and who appreciate all, as distinct from only a few, of the factors at issue, it becomes obvious that if demand and supply for foreign currency are fluctuating continuously, there is little merit in trying to peg the price permanently in the hope that the secondary reactions on the general price level (which may take many months to mature) will set in motion only just the *right* amount of internal price depreciation (or appreciation) to secure that particular equilibrium of extra exports (or imports) which may be needed to secure equilibrium in the balance of payments.

The danger of the fixed gold exchanges is that because they are extremely *slow* in their operation, they not only are slow in setting corrective price movements in motion, but usually cause the movements in internal price levels eventually to be *over-done*, so that much *more* fluctuation is caused in internal prices than is really necessary. Moreover, the fact that the initial fluctuation itself is slow in coming into operation, and is not immediate, causes a positive growth of the initial disequilibrium, which is bad for the nation as a whole.

It is true that in the end the corrector does begin to operate, but there is then a much bigger amount of corrective work to

be done than would have been necessary if the corrector had begun to operate immediately, and if net external prices had moved at once. Moreover, there is the secondary trouble that the corrective force itself, instead of stopping as soon as it has done its necessary work, usually sets up a new large error in the opposite direction.

In other words, a slow-acting change in net external prices, such as is provided by the gold standard, causes much more disequilibrium to mature in both directions than a quick-acting corrector, such as is provided by fluctuating paper exchanges.

Our conclusions from this argument are that both the internal and the external trade of a country are much more upset by a rigid gold standard than by a fluctuating paper standard. Paper, in fact, although it fluctuates, causes *less* economic instability than gold.

* * *

I also believe, although it is impossible to prove it statistically, that more international trade will be done under a controlled paper standard (with a well-organised forward exchange market) which fluctuates only slightly about an ever-changing true equilibrium level, than under a rigid gold standard, where *general* price fluctuations are occurring about the equilibrium level.

The paper exchanges will, it is true, fluctuate much more often; but the total movements in prices *as a whole* will not be so big as under gold, nor will they swing for so long or so far.

Thus, in the long run, internal trade will be less impeded by managed paper, with a well-organised forward exchange market, than by a rigid gold standard.

Each international transaction will certainly be more worrying to the trader concerned, but since the rate will probably never move very far from the true equilibrium rate, the maximum amount of international trade will be done and the utmost advantage will be thereby obtained from the international division of labour.

The costs of transacting all foreign trade will certainly rise slightly, and there will be the additional uncertainty of fluctuating exchange movements; but if as a result of well-managed paper internal trade becomes highly prosperous, imports in most countries will increase as internal prosperity increases, and exports will increase in their wake. The result will be that international trade will expand in the *aggregate*, partly because domestic trade is so prosperous and partly because the exchange rates are left free to hover around the ideal, though statistically unascertainable, equilibrium rate.

This is why I venture to suggest that managed internal paper money, coupled with unmanaged fluctuating exchanges, will in the long run bring about a positive expansion of international trade and finance. To short-sighted persons it seems absolutely *inevitable* that unless the foreign exchanges are stable, international trade and investment *must* decline. In reality this seems to be a misconception.

Mildly fluctuating exchanges may rule out a small amount of international trade, but they will only rule out that portion of total world trade on which the profit is so small as to indicate that there is no great net world benefit from its existence.

Moreover, in recent years under the gold standard a rigid import control has arisen because of the unwillingness of politicians to submit to the rules of the gold standard, and much more international trade has probably been frustrated by political interference than would have been frustrated by the minor fluctuations that are the natural consequence of the free working of the paper exchange market.

Our main point, however, is that although the paper exchanges are supposed to cause more economic disturbance than gold, the reverse conclusion would appear to be more accurate; since the workings of gold are habitually so slow as to allow the initial disequilibria to go unchecked for a while, and then later to cause a new, and equally slowly checked, disequilibrium in the opposite direction. The movements under gold, though admittedly less frequent, last longer and are more economically disturbing.

7. *Paper Exchanges are at the Mercy of Speculators.*

The next objection to paper exchanges is that they become the sport of currency speculators, and that foreign trade will suffer on account of the extra large movements which speculation causes.

But if paper is properly controlled internally, speculators will have little to go for in the shape of very wide exchange movements. Moreover, if they are wrong and unskilled in their forecasts, bad speculators will soon lose their money and will cease to operate; on the other hand, if they are right they will make money and continue. What is more, if they are right, they perform a very useful economic service by speeding up any exchange movement that may be in the offing and which would otherwise be delayed; in so doing they prevent the lengthy bolstering up of an uneconomic price, and thus put in motion at once corrective forces which the sooner they operate the better.

According to economic theory, professional speculators should *not* be discouraged in any market which itself is speculative, for it is their presence alone which enables *bona fide* traders to shift their currency risks, which they do not themselves want to shoulder, on to those who are able and willing to bear them. Risk-bearers, at times, may do harm by being wrong; but if they generally are right they benefit the community.

8. *Paper discourages International Investment and World Economic Development.*

Yet another argument against paper is that world progress and world trade * largely depend upon international lending and long-term investment; while if the gold standard is abandoned, international lending will permanently cease and

* The belief that export markets must be fostered by foreign loans, so as to clear the surplus products of one's domestic plant, is considered in Volume III, where the problem of domestic under-consumption is dealt with.

international trade will remain at its present disastrous low level.

Indeed, according to some of the proponents of the gold standard the chief reason why international trade has become so depressed is that international lending has ceased. Supporters of this theory point to the depression in the British engineering industry and say that if only international lending could be increased, the heavy engineering trades would revive.

In this argument there is some element of soundness. And I agree that in the absence of gold clauses international lending would probably tend to diminish, at all events until it had been proved that managed paper was an even steadier standard of value than gold.

The gold clause has, however, proved itself of little worth in the last few years. Promises have been made to pay in gold but when it has become politically inconvenient, these promises have been broken, even under the gold standard. This, however, is perhaps beside the point.

The real point is that if one country lends to another it does so, or at any rate it *should* do so, only if it believes that the borrowing country will eventually be able to export enough goods to earn sufficient of the creditor country's currency to pay back the original debt in full. The lenders should therefore be quite content to see their loans floated in terms of their own currency.

Debtors, similarly, if they honestly foresee the probability of being able eventually to pay interest on their loans and later to repay the principal in full, should hold the belief that their own enterprises and those of their country *as a whole* will be sufficiently successful to earn the real wealth with which to effect these transfers, via money, to the lending country.

They should bear in mind, moreover, that even if the exchange of the debtor country slumps some 20 per cent., such a decline will, other things equal, stimulate exports from the debtor to the creditor country, thus making the international transfer problem easier, though more expensive. It

will certainly cost the foreign borrower 20 per cent. more in terms of his *domestic* money, to pay the interest and principal; but in many cases prices may have risen within the debtor country somewhat parallel with the decline in its exchange rates, so that any given company will perhaps be earning a greater amount of internal revenue *pari passu* with the decline in the exchanges, so that in "real" terms the debtor company may *not* find it any more burdensome to meet its foreign obligations; it will certainly have to pay more domestic money for its foreign exchange, but it may well have a larger income from which to make the payments.

I am therefore inclined to believe that if a would-be foreign borrower does not think himself capable of carrying out his loan liabilities in terms of the lending country's currency, he has little business to borrow, and the lender little business to lend.

Moreover, the reader will, I think, agree, when he has read Volume III, that lending to foreigners is not nearly so sound a policy of stimulating the sales of our manufactures as our forefathers believed; for in the past foreign loans by England, France and America have very often taken the form first of loans for foreign development, then of additional loans to enable the debtor to pay interest, then of further loans to enable maturing principals to be repaid. In numerous instances the creditor countries merely gave their goods away to the foreigners, although internal trade all the while was being stimulated by the bolstering effect of the foreign loans. Innumerable foreigners have, however, eventually defaulted as soon as the creditor countries ceased pyramiding additional loans to support the old interest and principal payments of their debtors.

Furthermore, it has been calculated that the net interest of British overseas investments over the last eighty years has worked out at under 2 per cent., owing to defaults not only of interest but also on principal. More, however, will be said on this question when we come to discuss the economics of international lending in Volume III.

9. *By checking Foreign Trade, Paper encourages Economic Nationalism.*

Yet another argument put forward against the paper standard is that the uncertainty which it causes, coupled with the extra cost of covering forward exchange rates three months ahead, will bring much international trade to a standstill, thereby depriving the world as a whole of the benefits of the international division of labour, and fostering economic nationalism.

Here, however, the point that is usually missed is that in cases where the profit margin in international trade is so small that the extra cost of forward exchange dealing will wipe out the profit, it is *ipso facto* a sign that there is little difference in " comparative national efficiency " in that trade, and that there is consequently no great argument in favour of it continuing.

It seems, moreover, that, in order to prevent the gold standard from working according to its Spartan rules, much more economic nationalism is fostered than is ever likely to be fostered by managed paper.

10. *Conclusion.*

In dealing with the " case against paper " we have argued in almost every case that paper will be better than gold not only for the nation as a whole, but also for foreign traders and international financiers. It may therefore appear to some that we are trying to prove too much; we may seem to be overstressing our arguments.

But the reason why, in almost every case, we find reasonably managed paper better than reasonably managed gold, is that paper allows the laws of supply and demand to operate healthily in both the domestic and foreign monetary sphere, whereas gold prevents their healthy operation. It is for this reason—and not on account of any cunning manipulation of arguments—that paper must emerge triumphant from our analysis. If gold were better we would want to retain the gold system; and we should strongly advocate restabilisation.

The crucial point, however, is that there must be an international corrector. Paper is the quickest, the fairest, and the *least* disturbing, although it is disturbing. Paper, moreover, does not prevent the adoption of those remedies by which alone the modern business cycle and unemployment can be prevented.

The national foreign exchange mechanism should be decided upon by level-headed statesmen, who, although listening courteously to all the conflicting arguments put forward by sectional interests, should base their decisions on what is best for the country *as a whole*; and who should not allow this decision to be affected by the noisiness or short-sightedness of any one particular group.

It is largely because people simply do not understand the workings of gold, or paper, that gold has so many adherents. Gold looks more attractive on the surface. In reality it stabs its admirers in the back.

CHAPTER XVIII

THE FIGHT FOR SOUND MONEY

1. Vested interests.
2. The experts on the subject.
3. Monetary reasons for the growth of Socialism.
4. Capitalism has never had a chance.
5. Four types of monetary mismanagement are normal.
6. Sound money is the answer to Socialism.
7. Six institutional causes of bad trade.
8. A battle of principles between vested interests.
9. How exporters are hurt by the rigid gold standard.
10. How international bankers are hurt.
11. How the public half-heartedly worships false gods.
12. The Press and its influence.
13. The crux of the problem.

1. *Vested Interests.*

In a controversy such as that now raging between the gold and paper enthusiasts feeling is bound to run high. Each side is inclined to label the other with such epithets as short-sighted, unbalanced, reactionary, illogical, Utopian, and dangerous.* I have already borne my fair share of such criticism. Nor does the argument stop at mere labels: personalities and vested interests are also introduced. The paper party, for instance, is accused of advocating inflation in order to promote the equity profits of their own businesses. I myself have been accused of pursuing a vendetta against gold merely so as to make my forecast "that gold will eventually slide out of use" come true. But I do not complain.

* All change is regarded as "dangerous" by the elderly. They fear the unknown; they detest all experiments; they want to get back to the conditions of their youth. Pre-war conditions represent their idealism and their goal. They do not want to have to learn new methods; and they shun the idea of having to adapt themselves to the post-war environment, a kaleidoscope state of affairs which their own lack of financial wisdom has given their children as an heritage.

As Galsworthy has it: "Principles—he mused—*au fond* were pocket; and he wished the deuce people wouldn't pretend they weren't! Pocket in the deep sense of that word, of course, self-interest as member of a definite community." * Galsworthy perhaps made Sir Lawrence Mont too pessimistic about human nature; but it is difficult to deny that environment and pocket have a powerful influence on one's own political and economic principles. Take, for instance, the Court of the Bank of England, and see what beliefs they are "likely" to hold. There are twenty-six members of the Court, none of whom is a director of the five big commercial banks. Fourteen are international bankers proper, and therefore definitely likely to advocate stabilised exchanges. The remaining twelve may certainly be said to be industrialists; but all except three of them (namely, Sir Andrew Duncan, Chairman of the Central Electricity Board; the Hon. R. D. Kitson, D.S.O., of Dorman Longs, and many other iron and steel companies; and Sir Josiah C. Stamp, G.B.E., Chairman of L.M.S. Railway), are definitely and primarily *international* traders in either shipping, cables, coal or Canadian exports. Three of the twelve moreover (Mr. C. J. Hambro, Sir E. R. Peacock, Bart., and Mr. Cecil Lubbock), are connected with international finance, *i.e.* Hambro's, Baring's and the Corporation of Foreign Bondholders, respectively.

Now it is no easier for the majority of these gentlemen to support anything except stabilised exchanges than it is for a camel to pass through the eye of a needle. I do not wish to impugn the honour of these gentlemen or to imply that they put the welfare of their own businesses before the welfare of the country; it is obvious they do not. But as I know myself only too well, if one lives in a given City environment, it is difficult to hold any economic views which react against the prosperity of one's own particular business.

Moreover, note this. Owing to the pressure of work

* Sir Lawrence Mont, the company director, pondering a problem, in *The White Monkey.*

upon the time of men at the head of affairs, they have little leisure left to study the views of, or to meet, persons in a separate economic or mental environment. The group moreover tends to hold the views at which it probably arrived at an age before responsibility came its way. Out-of-dateness in thought is more normal than abnormal.

An elderly international banker is, however, habitually, and somewhat naturally, regarded as an expert on all problems of foreign exchange and money, since these problems fall into his daily business. But to regard all international bankers as reliable experts on monetary policy may be dangerous from the *national* point of view. A man may be a successful international banker without knowing particularly much about the State problems of the business cycle and the causes of unemployment. Moreover, international bankers and international traders must be supermen if they do not tend to look at national welfare to some extent from the point of view of their own immediate business environment. Nor do I for one moment claim to be immune from this inclination myself. I find myself in a continuous tendency to believe that what suits my own pocket must also " obviously " be for the general good of the country.

But statesmen should take a nation-wide view-point; and although it is right for them to listen to the views of international bankers and traders, they must realise it is not impossible that the opinion of these experts may be tinged by pocket and environment. The same view is also sometimes expressed concerning Civil servants and professional economists. Most of them are paid a fixed salary and possibly, later, a pension; and for such persons, therefore, deflation is probably more beneficial than price stability or reflation.

To pretend, however, that all Treasury officials, economists, and Members of the Court of the Bank of England are biased by their pockets and their economic surroundings would, of course, be mere foolishness. Indeed I know a great many of them myself who take a peculiarly impersonal point of view.

But although not wishing to contend that all persons with vested interests are governed in their views by their pockets, I am equally anxious to avoid affably pretending that there are not a great many to whom these imputations apply. If the reader thinks that I am making unfair allegations let him read the evidence tendered before the Macmillan Committee on Finance and Industry, and such information as is known concerning the Cunliffe and Bradbury Committees.

Hence for the government to consult the international banking community, or the Directorate of the Bank of England as at present constituted, is merely to consult a body of men who, by the very nature of their callings, are *probably* somewhat biased; and therefore perhaps *somewhat* inclined to recommend policies which will benefit the members of their own economic environment, possibly to the detriment of the country as a whole. Governments should remain alive to this danger.

2. *The Experts on the Subject.*

There is, moreover, a second point at issue. A man may be a first-class banker, and conduct his business with the utmost success; and yet know nothing of the theory of money (although he helps to manufacture it), or of the defects in the monetary system in which he earns his living. As was shown in Chapter XII, prudent banking often leads to monetary chaos; and as we shall show later in this Chapter, lending and loan withdrawal, which may be sound from a banking point of view, may be, and indeed usually is, at four successive phases of the business cycle, positively harmful to the national economy.

To regard the bankers of the City of London as reliable experts on money and economic fluctuation, merely because they deal in money, may therefore be dangerous. Although the popular view is that since these well-known figures are professionally engaged in international finance and domestic bank-

ing, they must therefore "know all about it,"—in actual fact, if one listens to the annual speeches of the leading bankers of Great Britain, one will find a divergence of view which clearly proves, in the light of the disagreement expressed, that not all of them can possibly be experts. If some are right, the others must be wrong, for their views are often diametrically opposite. Nor, in most cases, do they provide any satisfactory explanation of the cause of want in an era of plenty. Few of them seem to have studied the business cycle, and only one or two are willing to admit that there is anything wrong at all with the modern monetary and banking system as a whole; they idly find the reasons for modern depression in that most convenient of all scapegoats, the War.* Too many of them, moreover, are inclined to uphold the ignorant view that the banks are merely *passive* agents, which cannot *actively* influence the course of general industry at all. If, however, the reader will glance through Appendix B, I think he will agree that the collective influence of the banks can at times be enormous. Their sometimes harmful influence on trade is, I agree, not in any way the *personal* fault of the bankers themselves, but due rather to institutional defects in our monetary system *as a whole*. If, however, our bank chairmen take the attitude that the banks in general do *not* influence trade (fortunately not all of them do this), it seems doubtful if they deserve to be considered as experts. And the same thing applies not only to monetary theory, but also to foreign exchange theory as well.

To me, of course, it is not pleasing to make these remarks concerning a rightly much respected group.† But no book on money would be complete without indicating where the balance of Power behind policy lies. There are vested interests; they are immensely powerful; their knowledge is limited; yet

* Many bankers are showing themselves little more than bewildered defeatists in their outlook on these national economic problems.

† Do not think that I have any personal animosity towards bankers as a whole; far from it; my great-grandfather, George Fife Angas, founded the National Provincial Bank.

governments bow to them. The world is in a monetary tangle. Unused brains at the top are the cause of our troubles.*

There are moreover certain dangers ahead.

3. *Monetary Reasons for the Growth of Socialism.*

Socialists and communists, rightly disgusted with the poverty and economic dislocation which have accompanied the capitalist system for the last 100 years, cry out for a change in the system itself. Their belief is that the Individualist system, motivated by profits, and controlled (as they say) by high finance, has in it certain inherent defects which will never allow it to function satisfactorily. They therefore have an urge to destroy, preferably at the next ballot-box opportunity.

Their complete condemnation of capitalism, however, is, I think, due to their own failure, and to that of the capitalists also, to diagnose the present-day diseases of capitalism.

Not knowing the actual causes of the recurrent breakdowns in trade and employment, the Socialists naturally fail to put their fingers on those monetary reforms which would enable the capitalist system to function to the ultimate good of all sections. Instead, they seize upon Individualism and the Profit Motive as the ultimate cause of the breakdowns in trade, even though any careful student of money can see that these are not the major causes of the failure of capitalism at all.

4. *Capitalism has never had a chance.*

The individualist system of capitalism has never yet had a chance; for it has never yet been provided with sound money for more than a year or two on end. And yet sound money is a first essential to capitalism, for on it depends the success of

* I respectfully ask sympathetic reviewers not to quote isolated excerpts from the above rather derogatory paragraphs, *unless* they include at equal length the gist of the rest of this chapter. I am naturally most anxious to avoid giving a wrong impression of a body of men most of whom are as sincere in their firmly-held views as are their opponents who advocate paper.

the long-term credit system, which is the very essence of capitalism.

There is another point at issue; the expansion of production, after a period of saving and capital expansion, requires *more* money, injected into circulation at the *right* time and the *right* place (see Volume I); and yet money has never been scientifically issued on these principles. Its total supply, moreover, has been limited by gold.*

Occasionally the capitalist system has made continuous progress for a year or two on end; but usually, *during* the progress, money, especially bank money, has been expanded *too* fast by thoughtless bankers collectively, with the result that a disturbing price inflation has occurred. Then later, after a few years of rather "unhealthy" prosperity, industry has come up against a hard core of legal tender, and a shortage of bank money has prevented further expansion. A period of tight money has then set in, and this has caused, first fear, then monetary hoarding, then falling prices, and subsequently positive contraction of bank credit, *i.e.* deflation. Capitalism has thus been made to take several steps back as a penalty for having tried to take a step forward.

Nor when the decline in prices has set in, due to monetary hoarding and bank credit contraction, have the monetary authorities (who have never really existed) taken any early steps to counteract either the increasing store-of-value *demand* for money or the decreasing *supply* of bank-credit-currency. Indeed, no intelligent anti-deflationary manipulations of Supply have ever been resorted to in response to the increasing store-of-value demand as reflected in a higher "Price," *i.e.* a lower commodity price level.

Thus depressions, caused mainly by ill- or non-managed money, have been allowed to acquire cumulative momentum "naturally," owing to the laws of supply and demand and price not being allowed to function in the sphere of the nation's money.

* The non-monetary causes of bad trade are dealt with in Volume III.

5. *Four Types of Monetary Mismanagement are Normal.*

Four phases of monetary mismanagement have, in fact, been habitual in all past business cycles.

In addition to the crimes—

(i) of money being expanded too fast in the middle stages of prosperity (thus setting a speculative boom in motion); and then

(ii) of money not being expanded fast enough later on when increased outputs from enlarged factory plant have begun to augment the medium-of-exchange demand for money; a third monetary crime has habitually been committed, namely,

(iii) of not increasing money when at last an increased store-of-value demand for money (owing to Fear) has started to make prices fall cumulatively; while finally,

(iv) when cumulative bank credit contraction, due to falling collateral values, has taken place (instead of expansion) and thus has "naturally" added fuel to the flames, nothing has been done, on the Supply side, to counteract this prudent though cumulative deflation.

This is not the *personal* fault of any individual banker. Far from it. Indeed if he did not personally take part in these various movements he would either lose profits or endanger his deposits. The fault is an *institutional* defect in the banking system *as a whole*; for the monetary system of the country has never been put under the charge of any individual, or group of individuals, to see that the "natural" defects, inherent in an otherwise admirable system, are scientifically countered or eliminated. The duty of the Central Bank has never yet been to see that the trade and price cycle is ironed out, but merely to keep the country on the gold standard. Lord Cunliffe has

declared it; Mr. Norman has declared it; and no one can deny this regrettable truth.

6. *Sound Money is the answer to Socialism.*

Capitalism, I repeat, has never had a chance. It has always been burdened and murdered by unsoundly managed money. And by tying internal money to the chariot wheels of gold, the diseases of industry have been all the more magnified.

Most Socialists (and capitalists *) hardly realise this. No wonder the former cry out for a new sort of system.

The only answer to Socialism is Efficiency. Efficiency will come, I assert, from sound money: that is, paper money, not tied to gold, and issued and contracted in order to counteract the swings in general prices (and trade) which will otherwise *inevitably* occur (*a*) in any country where people are free to hoard their money, (*b*) as a result of the modern cash-reserve-ratio system of *competitive* collateral banking, in which the community uses as money the pass-book entries of bankers, the supply of which is expanded and contracted by bank loans and investments.

This is certainly a mouthful of words to use in one sentence; but it is as a result of the joint operation of the six separate factors (mentioned in the above sentence) that the modern monetary machine breaks down.

The reason is not that the bankers are callous, negligent or criminal, as is so often supposed; but that they operate in a system which has gradually been evolved haphazard from *past* history, and in which there have consequently matured certain *institutional* defects. The blame, if any, must be put, not on men, but on custom and gradual Evolution. The existing disastrous state of affairs is certainly not the fault of any living individual or group.

* The economists have not yet deserved too well of their country. Few good books have been written on the subject.

7. *Six Institutional Causes of Bad Trade.*

Our monetary and industrial troubles result from the following six institutional defects and customs:

1. The cash reserve ratio system of banking. (See Diseases V and VI of Chapter XII.)
2. The competitive nature of banking, which means that no single bank can refrain from deflation if other banks are deflating (since that bank would lose its balance at the Clearing).
3. The fact that the public occasionally hoard money, thus reducing its velocity on to goods, whenever they are nervous (thus causing prices to fall).
4. That owing to the collateral system of banking, a fall in the prices of commodities and securities, due perhaps to factor 3, forces banks to call in loans.
5. The fact that what the modern public use as money (as to over 80 per cent.) is something, namely, an entry in a bank ledger and the customer's pass-book, which is expanded and contracted in aggregate quantity by the loans (and investments) made by bankers.
6. While finally, variations (i) in the confidence of bankers, which largely governs their willingness to lend and invest; and (ii) variations in confidence among the public, which governs their willingness to borrow, also largely govern the total supply of money; so that, if any one of the above-mentioned factors begins to operate adversely, confidence of bankers and the public is upset and the total amount of money in the country tends at once to be deflated for this reason, and to cause the depression to become cumulative.

As the reader will see, the above-mentioned miscellany of factors definitely constitutes defects in the modern monetary system *unless* there is a Central Monetary Authority whose

duty it is to counteract these *unavoidable* mass actions of the public and of bankers.

The reader, however, will similarly agree that the economic troubles which ensue from these various phenomena are *not* the fault of the bankers who call in the loans, any more than of the public who hoard money. For the public to *blame* their bankers is mere foolishness. They should, if anything, blame themselves for not insisting that a Ministry of Economics be set up, just as in some countries there is a Ministry of Transport, for certainly the *monetary* vehicles for the movement of goods are as important as the physical vehicles. To attack the banks, I repeat, is sheer nonsense, except in so far as the bankers fail to find time to analyse more deeply the defects in the system in which they earn their living.

The Socialists cry out: Let us nationalise the banks.* One can hardly blame them. But let the reform of our money be pressed for by the bankers themselves, and let them cease to pretend that there is nothing wrong with the modern monetary mechanism, which they themselves have *not* created, but which has gradually grown up from past history.

Brains at the top are certainly not lacking; knowledge, perspective and vision most certainly are.

The answer to Socialism, I repeat, is monetary Efficiency.

8. *A Battle of Principles between Vested Interests.*

What then does the gold standard versus the paper standard controversy boil down to? Purely this: an intellectual battle on matters of principle between experts, coupled with an economic conflict between vested interests: Army Number I consisting of international traders and merchant bankers engaged in foreign commerce and finance (including, of course, the gold-producing community), whose personal interests

* A banker is not required to act as though he were the national Minister of Money, but merely to collect other people's money and lend it out prudently, thus doing his best to stimulate trade. The Minister of Money should perhaps, as a side line, ensure that the bankers act prudently, but his main job is to prevent the cyclical swings in business and prices which *prudent* banking often entails.

naturally make them inclined to support the gold standard, so that the painful burden of the international corrector may be shifted on to the rest of the community; and Army Number 2, the rest of the community, who benefit from stable internal money rather than from stable exchanges.

The rest of the community is, however, inarticulate and confused, because, instead of being a compact and well-organised group working closely together in the City square mile, they are widely dispersed throughout the land and have no spokesmen except a few university professors whom the gold field-marshals habitually label as cranks and theorists. The paper army, moreover, is not only ill led and unorganised, but is also, owing to lack of any economic intelligence service of its own, unaware of the identity of its real enemies. Indeed, skilled enemy propaganda has convinced many of them that their real enemies are actually their friends.

9. *How Exporters are hurt by the Rigid Gold Standard.*

Take, for instance, the average exporter. He seeing rightly that a fluctuating exchange system makes each of his individual transactions more difficult, naturally pleads for a rigid exchange system. Never having had a theoretical economic education, he does not realise that the *cost* to the public of rigidly fixed gold exchanges is internal instability of prices, and that if, under the gold standard, a deficit has matured in the international payment balance, and gold is in consequence lost, the weakening of the reserves of the banking system leads to a continuous policy of credit deflation until at last the internal prices of almost all commodities, including exportable goods, have been forced down to a level which attracts further foreign buying. In other words, the gold standard is a system whereby the internal prices of exports particularly, and with them the profit-margins of the whole exporting community, have to be deliberately attacked whenever an adverse international payment balance has matured.* Exporters, it is true, may even-

* Under paper their profits are augmented, not reduced.

tually sell a greater *volume* of goods, but meanwhile their profit margins will probably have been wiped out. Yet the unfortunate exporters, thinking that the gold standard is a *primary* benefit to them particularly, advocate it, never realising its treacherous and harmful *secondary* implications to themselves.

10. *How International Bankers are hurt.*

Similarly as regards the international finance community of London. These gentlemen, almost without exception, support a rigid gold standard; and they believe it is in their own interests to do so. But why? It does not help them!

Ever since 1925 (when for the first time in the history of the world the gold standard was required to work on "authentic" principles) much *lip service* has been continuously paid to the gold standard system; but the democratic governments of the world, in actual fact, have all the time refused to play the gold rules correctly. Both debtor and creditor nations have progressively imposed tariffs *because* it has not paid them, in practice, nor was it politically possible, to work the gold standard according to its authentic rules. Thus the gold standard became a breeder of tariffs, and international trade in consequence broke down.

As international trade declined, international finance (which is the monetary counterpart of international trade) naturally declined with it. In this way the gold standard, although supposed to enlarge the scale of foreign trade and international investment, has had precisely opposite effects; giving to its most ardent supporters, namely international bankers and financiers, an unsuspected stab in the back. *Single* international transactions are certainly facilitated by fixed exchanges, but the authentic system leads, in practice, to secondary reactions which inevitably reduce their *total number*. The City of London inevitably suffers at the hands of its imagined best friend.

11. *How the Public half-heartedly worships False Gods.*

Finally, as regards the public. The public have been told

that if paper money is not backed by gold it will collapse; that the cost of living will rise; that all their money and savings will become worthless; while further, if the exchanges are not stabilised, exports will decline, and foreign food will be unobtainable. National starvation, a higher cost of living, and poverty are the natural corollary of a managed paper standard.

The poor British public, although not believing perhaps quite all that they are told, know that they have a hidden enemy, and know that they ought to fight somebody about something, but, like the Red Queen in *Alice in Wonderland*, they do not know quite whom to fight nor what they ought really to fight about. Their economic experience tells them intuitively that they have a hidden enemy somewhere, but "smoke screens" of suffocating theoretical fog, let loose not only by the real enemy, but also, I fear, by their own comrades and M.P.'s, obscure their foes from them. And, since they have no one on their own side to tell them the truth *intelligibly*, they naturally do not fight their own real enemies at all, nor rise up in arms against them. Just the reverse; they chase other more understandable hares. Some even go so far as to join the gold army whose poisoned bullets are inflicting them all the while with economic gashes and diseases.

Moreover, since the bankers in the City, who must automatically be experts, say that government interference in monetary affairs is bad for trade, and that paper money is even worse, the poor bewildered public are inclined to believe that since they themselves have not the equipment to put up a counter-argument against the bankers, therefore these imagined experts must be right. The public are therefore, in the hope of salvation, inclined to join the well-dragooned gold battalions, rather than the un-uniformed and unorthodox anti-gold motley.

12. *The Press and its Influence.*

Meanwhile countless speeches are made, and articles written in the Press, supporting the use of, or return to, gold.

The writers themselves are quite innocent of sin, because, like their employers, they are *unseeing*; they too, having once read Adam Smith, accept without question the orthodox tenets of gold.

The potential opposition army is therefore kept in a state of perpetual disaffection, mainly by propaganda to the effect that since exchange fluctuation is disturbing, gold must "therefore" be better than paper, and that the gold battalions are therefore the army to join. What hope, I would ask, is there of early monetary reform, or of reduced unemployment, when ignorance is so widespread and confusion so complete? Surface appearances alone are considered; deep analysis is regarded as the crazy hobby of cranks.

13. *The Crux of the Problem.*

Going back to the root of the matter, however, the problem at issue may be summarised as follows:—

> To regard the problem of the Foreign Exchanges merely as one of maintaining exchange stability is unstatesmanlike. The implications of stability must also be considered. First appearances are largely deceptive, for unless foreign trade is controlled by the government the exchanges have a definite function to perform, namely, to act as an automatic "corrector" to haphazard inequalities between imports and exports. There are only two alternative correctors, namely, fluctuating exchanges and fluctuating internal prices. The function of the exchanges is not to remove all forms of fluctuation, as is generally supposed, but positively to make "net external prices" fluctuate so as to augment exports, check imports, and secure the export–import equation. Thus money cannot be "sound," *i.e.* stable, both externally and internally—stable money and stable exchanges are mutually incompatible. A choice must be made of the lesser evil, the decision being taken from a nation-wide point of view.

Remember the six diseases of money (Chapter XII). They cannot be cured so long as the gold standard is retained. Is it wise, in view of these facts, for a country still to adhere to gold?

PART IV

PRACTICAL PROBLEMS

CHAPTER XIX

THE PROBLEMS OF RESTABILISATION

1. Guiding principles.
2. Technical difficulties.
3. The American difficulty.
4. Tariff difficulties.
5. The Gold Delegation's pre-requisite conditions.
6. The British official view. 1934.
7. The simple view and the expert view.
8. An Empire currency or a sterling standard.
9. Waiting for *de facto* stability.
10. The problem of gold redistribution.
11. Loans for restabilisation.
12. The probable future.
13. Survey.
14. Why not get rid of the problem ?

1. *Guiding Principles.*

Although not myself an advocate of any rigid form of restabilisation, the problem should not be omitted in a book of this nature.

First, let the reader glance back at section 5 of Chapter XI, p. 93. (*Please do so now.*)

The chief danger to avoid in restabilisation is the fixation of one's own currency at a level which makes it generally overvalued.

One should also be careful to obtain guarantees that no other important countries will *subsequently* peg their exchanges at levels which will make them unfairly undervalued; for if this happens, a drain of gold will commence, leading to the horrors experienced by England between 1926 and 1931.* There is, in fact, considerable danger in being the first country to act, lest undercutting by blacklegs should eventuate.

* The coal strike, and the General Strike, of 1926 were a direct result of returning to gold at an overvalued rate. It was not that the British working man was revolutionary, but that his economic position was becoming unbearable. Machine guns were seen in the streets.

But over-valuation as measured by purchasing power parity is not the only thing to look at. As was pointed out in Chapter VIII, it is important to look not only at the theoretically exact purchasing power parity but also at the tariff and debt factors—all of which, though easy to mention, are most difficult to allow for in practice.

It is also important, in countries where the price level has recently been deflated far below the relatively undeflated cost level in industry, to allow *in advance* for such reflation of internal prices as appears economically necessary; for if fair rates are fixed at present, in view of existing price levels, the subsequent occurrence of the needed internal reflation will make one's own currency overvalued, and one's gold holdings and foreign trade will be lost.

Here, however, a difficulty arises. If other depressed countries are equally anxious to reflate internally, but if the speed at which they will reflate is doubtful, each of them will also be anxious to allow *in advance* for their own reflation policies, and will therefore *also* be trying to secure, *at the outset*, some element of undervaluation. Not all countries can possibly do this. Indeed, unless these several countries can agree to reflate simultaneously to an equal extent, and at the same speed, none of them is likely to be able to come to any successful agreement with each other as to what constitutes the correct gold exchange rate *immediately* to fix. Each and every such country will, moreover, have grounds for feeling uncertain as to the reliability that can be placed on the declared reflation programmes of the others; for although a nation may desire and promise to reflate at a certain speed, it may not succeed in its policy in practice.

It is also to be borne in mind that although initially fixed rates may be fair and equitable, in view of present or even anticipated conditions, economic developments and internal price movements may *eventually* occur, which during a subsequent period may make the initially chosen rates ultimately unsuitable.

Tentative, *i.e.* variable, rates may, of course, be advocated;

but this does not constitute restabilisation " proper," although it constitutes " returning to gold." We shall leave the discussion of tentative and variable fixation until Chapter XX. In this chapter we merely consider the problem of rigid and *permanent* stabilisation.

2. *Technical Difficulties.*

It was demonstrated in Chapter VIII that it is impossible statistically to measure the correct exchange rate as between any pair of currencies, let alone as between the currency of one country and those of the rest of the world. (And it must be remembered that strictly speaking it is the network of a country's series of exchange rates which should be considered rather than the exchange rate as between any single pair of countries.)

But even if it were possible to ascertain by means of index-numbers the correct purchasing power parity as between any pair of currencies, the existence of true purchasing power parity does not itself guarantee that exports and imports will in consequence equate; differences in international tastes and in the intensity of international wants have *got* to be allowed for, since they may cause large variations in either direction (see Chapter VIII).

Even if these technical difficulties *could* be allowed for, and even if suitable allowances could also be made for *old* outstanding debts such as war debts, there is always the possibility, nay the certainty, of new debts and international loans being entered into which, in the future, will require either a new exchange equilibrium *or* a new inflation or deflation of the level of gold prices.

All these factors should theoretically, and in practice, be allowed for; yet it is impossible to do so. Which rather suggests that no *safe* decisions can be made at all events until war debts have been settled and virtually every country has effected such internal reflation as it deems necessary. And even that would not solve *all* the problems.

3. *The American Difficulty.*

Then there remains the American difficulty. It is generally believed that in view of America's dominant position both as a gold holder, and foreign trader, and world creditor, that no fixed restabilisation can be made by other countries until a definite declaration of American monetary policy has been secured.

Economic conditions in America, however, are so uncertain that even though no further change may at the moment be contemplated in the gold value of the dollar, the Administration will probably require to reserve to itself the right to devalue further *if* internal economic conditions should demand it.* Indeed since America cannot give *reliable* guarantees, restabilisation in Europe seems likely to be held over in many cases.

Finally, even amongst the European gold " bloc " countries, relative internal prices are so out of alignment, that even these countries cannot be regarded as permanently stable units to which it is safe for other countries to tether their currencies; especially as even among these on-gold countries a true gold standard is not strictly in operation. For, although to some extent they may be willing to sell gold in exchange for notes, their trade policies concerning tariffs and restrictions are not consonant with the working of a full gold standard system. And so long as this condition persists, it seems useless for the off-gold countries to go back to gold, since even the on-gold countries are not playing the rules correctly.

4. *Tariff Difficulties.*

In other words, the difficulties of measurement are not the only difficulties. A rigid gold standard can never be expected to work properly, *even if* the initial rates are rationally fixed and *even if* the various subscribing countries are prepared to

* It is even possible, if rapid on-gold inflation develops in the States, that the Administration may want to re-increase the gold content of the dollar as an anti-inflationary measure.

inflate and deflate their internal price levels whenever they receive or lose gold, unless there is also a definite international agreement that countries will *not* impose tariffs to prevent the movements of the goods which *should* follow in the wake of the gold; for it is a fact that if the international flow of commodities is prevented by tariffs, it is no use whatever for countries to return to gold even *if* they are willing to play the *other* gold rules (of inflating or deflating) correctly. If goods are not allowed to move; and if international debts and debit balances are to be settled *only* in gold, there is probably not enough gold in the world, at all events not in the hands of the debtor nations, to make these payments.

Certainly there is ample gold in the world (although it is not distributed equitably) *if* countries do not impede the movement of goods with tariffs; but if they continue raising their tariff barriers to stop the movement of goods, a rigid gold system *cannot* be expected to operate with success—even if the initial rates are scientifically chosen, and even if the various countries of the world play all the *other* gold rules correctly.

5. *The Gold Delegation's Prerequisite Conditions.*

Finally, in so far as various State Budgets are out of equilibrium, thus holding out the possibility of involuntary credit inflations, it would, according to some authorities, be unsafe to risk restabilisation until most budgets are again in a satisfactory equilibrium. Indeed, The Gold Delegation of the Financial Committee of the League of Nations, in their Report issued in 1932, laid it down that all of the following conditions should be fulfilled:

(i) Restoration of reasonable freedom in international trade.

(ii) That the central banks should not adopt an "offsetting" * policy to the loss or receipt of gold, but

* Offsetting is the word now popularly used to describe (i) internal credit expansions, when gold is lost, so as to prevent the gold export causing deflation; and also to describe (ii) the sterilisation of gold receipts, so as to prevent a rise in internal prices.

should adopt a guiding principle that gold movements should *not* be prevented from making their influence felt upon the credit position and the internal price level.

(iii) That a satisfactory solution of the Reparation and War Debts problem was necessary.

(iv) That there should be restoration and maintenance in each individual country of economic equilibrium, *including* the balancing of State Budgets on sound principles, and the adjustment of costs of production and costs of living to the international economic and financial position [whatever that means, if it means anything !].

6. *The British Official View.* 1934.

The British Chancellor of the Exchequer, with the full approval of the Empire countries, has also laid it down that prior to steps being taken to return to an international gold standard, which is still the declared ultimate goal, the following conditions will have to be fulfilled :

1. A rise in commodity prices which would bring prices and costs more into equilibrium ;
2. A removal or lowering of the barriers and obstacles to international trade ;
3. A final settlement of War debts, and
4. The finding of some means of avoiding fluctuations in the purchasing power of gold, arising from monetary causes.

He further added on December 21st, 1934, that it was necessary to wait until there was such a change in the internal price levels of America and France as might bring the dollar and franc into greater harmony with one another.

Whether it will be possible in the near or distant future to secure the fulfilment of all these conditions it is difficult to say ; but apparently they cannot all be obtained without international agreement ; and in view of the factors mentioned earlier

on in this chapter and also in Chapter IX, section 5, it seems highly unlikely that any international agreements will mature.*

In fact the whole question of restabilisation so bristles with difficulties that most countries are likely to continue playing a lone hand, hoping perhaps some day to return to gold, but in the meanwhile slowly forging new monetary systems of their own, which, if they fail to revive business, will probably be followed by restabilisation; but which, if they succeed, will probably remain permanent, with the result that gold may slide out of *effective*, as distinct from phantom, use.

7. *The Simple View and the Expert View.*

The man in the street, of course, may think that since a gold standard existed before the War, it ought to be easy enough to reinstitute a gold standard now (many bankers think it!), and that it is only the obtuseness of politicians which prevents an immediate return to "sound money." The man in the street, moreover, has been taught by the accepted "experts" to believe that immediate restabilisation on gold is necessary so that foreign trade, on which further internal economic revival in many countries is now *supposed* to depend, may be stimulated. Despite his experience of how the gold standard worked in practice between 1925 and 1930, he still repeats the fallacious parrot cry that *if* the exchanges are restabilised foreign trade *will* (inevitably) expand. He and his betters repeat this view, despite the absence of all supporting evidence.†

In other words, the man in the street holds the view that the gold standard *ought* to be returned to, and that it can *easily* be returned to.

When, however, one comes down to examine the technical

* Unless perchance countries are represented by men who do not understand the problem, and who will commit their countries to haphazardly fixed rates merely for the sake of a settlement.

† Some people even believe (entirely fallaciously) that there cannot be any further internal recovery unless foreign trade increases; and that therefore in so far as foreign trade can only increase if the exchanges are stabilised, restabilisation is the first prerequisite for any further improvement.

difficulties involved not only in any early action, but also in arranging that the gold standard will ultimately function properly *after* the initial return, one is forced to the conclusion that the man in the street, and his more august advisers, are over-simplifying the two separate problems at issue, namely, (i) that of effecting a return and (ii) that of working the standard satisfactorily afterwards.

8. *An Empire Currency or a Sterling Standard.*

Some observers think that since certain non-British countries have kept their currencies pegged to sterling within the last few years, the success of this policy demonstrates that the problems of the foreign exchanges can easily be solved; for, if the off-gold countries can peg their exchanges to sterling, surely sterling can be pegged back on gold. It can, of course. But what of the price?

It is a fact, moreover, that in so far as the countries which have linked their currencies to sterling have different banking systems and different note issues, as they have, they sooner or later will have to inflate or deflate, or impose tariff restrictions and controls, if they are to remain linked to sterling. As was shown in Chapter I, there must be an international corrector between every country with a different banking system; and net external prices *must* be made to fluctuate unless foreign trade itself is restricted and controlled.

Another group of persons seems to think that if different countries live under the same Imperial flag, they can therefore, *ipso facto*, have stable Empire exchanges; but in jumping to this conclusion they overlook the fact that it is not differences in flag or race which create the foreign exchange problem, but differences in note and banking systems (see Chapter I). Temporary pegging and Gold Exchange systems can certainly be put into operation, but in such cases the Gold Exchange rules must be played correctly and strictly; and this involves either inflation or deflation, or the building up of loans, unless trade itself is controlled.

9. *Waiting for* de facto *Stability.*

A last school of thought holds the view that although stabilisation is desirable, any return to gold should be avoided until sterling has remained stable in relation to, say, the dollar or the franc for a period of, say, three to nine months. It is believed that a temporary period of stability of this nature will indicate that the exchanges have in practice returned to their " natural " level and that restabilisation can therefore be safely effected. Such a contention, however, indicates lack of acquaintance with the factors governing exchange rates. A market rate may, it is true, remain stable for several months on end, but meanwhile orders for goods and debts may be being contracted which later on will require a new and different equilibrium rate. Temporary stability for a few months means nothing. Numerous instances can be found to support me in this point of view.

10. *The Problem of Gold Redistribution.*

Quite apart, however, from the unwisdom of using the market itself as a guide to the most suitable *permanent* rates, and quite apart from the difficulty of assessing what rates ought to be by statistical methods, there exists the problem of the redistribution of the world's gold stocks.

At present the world's stock of gold is believed to be between £2,500 million and £3,000 million (at old parities), of which about £2,000 million constitutes the monetary stock.

Annual production is about 24 million ounces or £102 million at 85*s.* per ounce. Annual production is thus roughly 5 per cent. of the total monetary stock.

At the time of writing, three countries, America, France and England, are in the position of having captured about three-quarters of the whole of the world's monetary supply (see chart on p. xi).

This is a ridiculous state of affairs. One-seventh (15 per

cent.) of the world's gold-using population holds three-quarters (75 per cent.) of the world's monetary supply.

Some redistribution from America and France in favour of the rest seems desirable—unless perchance the rest of the world is content to use these two non-internationally minded countries as its central bankers, which is highly unlikely, since they lack the experience, the apparatus and the necessary staffs.

The only ways of redistributing world stocks, as stated in Chapter XI, are:

1. By the off-gold gold-lacking nations taxing their people, or raising loans internally, or inflating * their currencies internally, and using the proceeds over the foreign exchanges to buy gold abroad; and then, when they have accumulated enough, returning to gold, probably at somewhat undervalued rates.
2. By the gold-lacking nations going back on to gold at such undervaluated rates, as compared with the other on-gold countries, that they will be enabled to contract a huge export surplus, which would eventually earn for them gold from abroad and lead to its importation, as happened in France in the 1926–28 period, when she fixed her currency at an undervalued rate.†
3. By the gold-lacking countries borrowing gold from America and France, and using the proceeds as a new basis for their currencies. It is not improbable, however, that the gold-holding nations will be unwilling to grant such loans because of their foreign loan experience around 1927.

* Inflationary purchases cost the government or Central Bank nothing.

† This, however, would probably *not* meet with the approval of the present gold-holding nations, for it would mean that their trade was undercut internationally, and they would probably be inclined to put on tariffs, not so much to check the loss of gold as to prevent the influx of cheap foreign goods. Such tariffs would, however, *prevent* the gold-lacking countries from getting any gold.

In view of these practical difficulties of gold redistribution a great many of the gold-lacking countries may decide either to adopt the Gold Exchange standard,* or to remain off gold altogether, allowing their exchanges to fluctuate in accordance with the laws of supply and demand. They might even unload their existing small gold holdings on to other on-gold nations in settlement of debt, as Australia has done, thus tending to increase the creditor's already large holdings and bring about internal price reflation in these on-gold countries.

11. *Loans for Restabilisation.*

At this juncture the question of the gold-glutted countries making loans to the gold-lacking countries deserves consideration.

Looking at the world from an international point of view, it appears to many that world rehabilitation will largely depend on the willingness of America and France to make loans abroad; but looking at such lending from the point of view of Americans and Frenchmen, they will probably be unwilling to invest abroad unless the loans contain a gold clause or unless the borrowing countries have themselves *already* returned to gold. Indeed it is sometimes stated that no loans will be possible until *after* the exchange and currency tangles of the present day have been straightened out. This demands that nations should put their own houses in order *before* the loans (needed to put them in order) can be forthcoming!

It is conceivable, of course, that sooner or later the gold-holding nations, in the belief that their prosperity can never be great until world prosperity returns, may be induced to lend their surplus gold abroad to the gold-lacking nations, in the belief that general restabilisation will restimulate foreign

* Under a so-called Gold Exchange standard the gold-lacking country, after having earned or borrowed a credit in some other on-gold country, manipulates its internal credit and prices (and possibly controls imports and its foreign exchange market as well) so as to keep its exchanges fixed at the selected rate with the fulcrum country.

trade, and also domestic prosperity with it. But early action on these lines seems unlikely: the gold-holding nations are only likely to lend to the others when they regard such lending as a reasonably safe risk; and until world prosperity has already revived, the risk will hardly be regarded as safe.

In actual practice, therefore, if gold redistribution takes place at all there will probably be a compromise between earning gold by under-valuation (either on paper or with undervalued gold rates), and borrowing it. Any attempts at the former policy, however, are likely to be partially frustrated by tariffs; while loans in many cases may be refused until the depressed countries have revived their internal trade and their budgets—when the loans themselves will no longer be so necessary! Gold redistribution, therefore, prior to world revival, is rather an unpromising condition to hope for.

12. *The Probable Future.*

The currency policy of the off-gold countries may therefore primarily be one of Internal Reflation of price levels, into line with relatively undeflated cost levels, effected either (i) on paper, or (ii) on gold, with either heavily devalued or mildly undervalued rates. And during the reflation they may control their exchange markets, and their imports, in such a manner as to prevent exchange disequilibrium and foreign influences *effectively* frustrating their internal price policies.

It is true that some of the gold-lacking countries may select one or more of the currencies of the gold-possessing nations and link their currencies to them on the Gold Exchange system. Indeed, at present this appears to be the policy which several gold-lacking countries are quite likely to pursue. But even so, the problem arises as to which of the at present on-gold currencies they should select as the fulcrum for the Gold Exchange system. The trouble is that even the existing on-gold countries may vary their rates considerably; consequently the adoption of a Gold Exchange system by the gold-lacking nations does not seem likely to be risked for some while.

The tendency, it appears, however one looks at it, is for the rigid gold standard to remain out of use, and for restabilisation to be more or less permanently shelved, although much lip service will doubtless be paid to it as the ultimate goal.

It would seem, moreover, that even the amount of lip service paid to gold may greatly decline, as more is learnt about the nature of the various forms of gold standard, and the causes of business fluctuation. At present so little general knowledge exists on either of these subjects, even among the accepted experts, that surface conclusions alone are jumped at. As progress is made, however, in the knowledge of money and business fluctuation the intuitive worship of gold may decline. Restabilisation may therefore be shelved, not merely because of its technical difficulties as at present, but because of a decline in the belief in its wisdom.

13. *Survey.*

To many, of course, it may appear that we are complicating the problem unnecessarily, and that since for many decades a rigid gold standard worked without disaster prior to 1914, therefore the problem of restabilisation is much simpler than we have made it out to be. But let those who believe that the problem can be simplified ask themselves, Why did the gold standard work more or less satisfactorily before the War? Was it not because England, in addition to being the world's central banker, was also the chief creditor *and* a willing foreign lender? In the absence of these conditions in America and France, can the gold standard be expected to work except according to the "authentic" rules? And is it not a fact that most countries are now on principle unwilling to play these Spartan rules correctly, *i.e.* to deflate when they lose gold, and to inflate when they receive it—even though the international gold standard rules make it "theoretically" necessary? Moreover, are there *any* countries which are willing to refrain from imposing tariffs, merely for the sake of making the gold standard work authentically? Under these conditions, do not

international debts have to be settled in gold * rather than in commodities? And are the gold supplies of the debtor nations adequate to effect these payments, and yet still to allow the debtor countries concerned to remain on gold?

If the reader can give a satisfactory answer to the majority of these questions, restabilisation should be fairly simple to effect—even though a fixed exchange system may not be as economically satisfactory as a fluctuating paper exchange system. On the other hand, if only negative answers can be given, we must not be accused of over-complicating the issue.

This, of course, is not to say that many countries will not return to gold. Honest beliefs are held that it is prudent and wise. The result in practice will probably be that foolish things may be done in the monetary sphere once more.

14. *Why not get rid of the Problem?*

To some, of course, it will appear that the problem of the exchanges "should not be allowed to exist" at all; but, as was explained in Chapter I, this is impossible unless either (1) all countries adopt a universal monetary system (of gold or paper) *without* superimposing thereon a non-universal note and banking system; or (ii) unless an international bank deposit currency is instituted. In other words, the only two methods by which the foreign exchange problem can be eliminated is by the abolition of modern banking as we know it, or by instituting one great universal bank whose deposit entries, transferable by cheque, shall circulate in *all* countries.

Unfortunately, however, such a system is at present politically impossible.

* If America refuses to take goods, the fact that she is owed £3,500,000,000 (at five dollars to the pound) by foreigners, with an interest rate of say 5 per cent., means that an annual payment of £175,000,000 is necessary. This represents 25 million ounces of gold at seven pounds per ounce. Annual gold production is only 24 million ounces; therefore America (on this basis of reckoning) would have a lien on the whole of the annual production of gold.

CHAPTER XX

THE POSSIBILITY OF VARIABLE GOLD STANDARDS

1. The plea for a variable gold standard.
2. Objections to a variable gold standard.
3. A variable gold standard with a limited variability.
4. Temporary methods of securing both stable exchanges and stable prices.
5. The possibility of compromises.
6. An elastic arrangement of variable gold exchange rates based on an index of internal prices.
7. Objections to the scheme.

1. *The Plea for a Variable Gold Standard.*

Many thinkers, although admitting the defects in the automatic gold standard and the inherent defects in the modern monetary and banking system, are nevertheless not sufficiently confident in politicians, or in economists, to go the whole hog and scrap the gold standard immediately, deliberately adopting fluctuating exchanges and manipulated paper instead. But they see a way out in what is called the Variable Gold Standard, *i.e.* a mongrel variation between rigid gold and manipulated paper, which would have the advantage that if the experimental (semi-paper) system failed, rigid gold could once again be reverted to.

According to this school the most practical solution seems to be: (i) to aim first at internal price stability and to manipulate the internal paper currency accordingly; and yet at the same time (ii) to return to gold-convertibility, but, instead of trying to maintain a perpetually fixed gold conversion rate, to let the Central Currency Authority alter from time to time, and step by step, the gold content of the pound, as conditions may demand—just as at present the bank rate is arbitrarily altered, step by step, as and when it is deemed necessary. The Central

Authority would alter the rate of exchange according as it observed any strong tendency for the demand for foreign money to exceed the supply, or *vice versa*. There would thus be considerable stability of internal prices, coupled with only occasional variations in exchange rates.

If they so wished, business men, under this system, could shift their exchange risks, since a strong forward market would doubtless be organised. Thus, in the short run, international traders could hedge against their short-run commitments.

The responsibility of the Central Authority in intermittently stepping the gold-content or conversion-rate of the £ up or down, would, of course, be great, but no greater than that now imposed upon it with its intermittent alterations of the bank rate and its control of total credit through open-market operations so as to keep the country on gold.

2. *Objections to a Variable Gold Standard.*

Although a variable gold standard may seem a happy compromise between a rigid gold system and controlled paper (with its corollary of *continuously* fluctuating exchanges), a brief examination of its implications will disclose that in practice the system is probably only suitable for countries with comparatively small and unimportant export trades. For if large and important countries adopt this procedure, it would be likely to lead not only to a competitive devaluation race as between the different industrialised on-gold nations, but also perhaps to an era of progressive on-gold inflation. Let me explain.

Under such a system it is obvious that if any one country found itself losing too much gold owing to over-importation, despite its internal price level being stabilised, the country concerned would raise its statutory buying price for gold and thereby depreciate its exchange rates relatively to those of other nations. This would have the early effect of checking imports and stimulating exports—probably leading eventually to a

second influx of gold probably big enough to replace the amount of gold originally lost.

While this gold replacement process was going on, however, other nations losing gold, coupled with a competitive increase in their imports and a decline in their exports, would probably be induced to raise their gold prices also.*

This would at once destroy all chance of the first nation lowering its gold prices as soon as it had made good its original gold losses ; and, in so far as other nations pursued a competitive gold-raising policy, the first nation would perhaps feel inclined to step up its gold price competitively once more.

In fact, there would probably be a tendency for nations which had raised their gold prices and devaluated their exchanges *never* to lower them again, lest such action should once more set in motion another loss of gold and/or an on-gold domestic deflation.

The net result would probably be a competitive world devaluation race, countries using the devaluation weapon just as, under the old gold standard, they have recently used the tariff weapon to protect not only their gold reserves, but also their domestic and export industries.

If one or two small countries, such as Holland and Switzerland, adopted a variable gold standard it would probably not be of much importance to any of the Great Powers on a fixed gold standard, since the damage which the small countries could do them would probably not be disastrous. But if any one great export Power undervalued its exchanges relatively to another (as France did in relation to England from 1925 onwards, or as America did in January 1934), retaliation, either in the form of higher tariffs or competitive exchange devaluation, might become necessary. The logical conclusion, therefore, is that a variable gold standard, despite its superficial attractions, would not provide any permanent long-term stability (such as is wanted by long-term investors). Indeed,

* Just as gold-desiring nations competitively raised their bank rates in the late 1920's.

instead of fluctuating *about* a given level, their fluctuations would tend to be downwards only, and a gradual world devaluation race would ensue—coupled probably with ever-growing tariff walls in order temporarily to delay the further marking down of exchange rates, *i.e.* the further marking up of gold.

This, however, might not be the only disadvantage. Successive upward revaluation of existing gold reserves widens the metallic basis for bank credit, and might set in motion a credit and price inflation. In fact, the world might enter upon not only an exchange devaluation race, but also an orgy of on-gold price inflation. Surplus gold reserves certainly *can* be sterilised, but it does not necessarily follow that they would be.*

* * *

Indeed, if one country adopts a variable gold standard at an undervalued rate (as America apparently has done, at all events temporarily), an appreciation among the world's statesmen of the risks of a competitive devaluation race (and of the subsequent danger of an on-gold inflation), instead of encouraging other nations to go back to gold, will probably make them hesitant—particularly if their internal trade and their domestic price levels were already rising.

Moreover, if the present under-valuation of the American gold dollar forces any of the existing on-gold nations in Europe off gold, instead of their immediately returning to gold at some new fixed or "tentative" devaluated rate, they may perhaps adopt a waiting policy and stay off gold until America has reflated her internal prices to the level she thinks most suitable for her new economy (? 1926 level).

Then the European nations forced off gold might possibly consider permanent re-stabilisation; but so long as the American

* In this respect it is interesting to note that the revalued gold reserves of America are already large enough to support an internal price level some four times higher than that now current, *without* infringing any of the existing bank reserve ratio laws. Some observers would figure much higher. Thus those who advocate working the gold standard "according to the rules" are the real inflationists, little as they know it.

government possesses the power to devaluate further they will probably hesitate to adopt any *permanently* fixed parity.

Moreover, if and when they do take action they will then probably choose undervalued rates—which might induce America herself either to devaluate further or to raise her tariff walls in order to prevent gold exchange-dumping.

One or two countries may, it is true, run off a few competitive heats in the gold-devaluation race, but the gold Race-meeting will probably be abandoned eventually; with the likelihood that managed paper, coupled with fluctuating exchanges, may eventually creep in in its stead.

3. *A Variable Gold Standard with a Limited Variability.*

The gist of the foregoing remarks is that the logical outcome of a variable gold standard would be a progressive, competitive devaluation race, thus depriving the international investing community of what they particularly wanted from the foreign exchanges, namely long-term stability.

In order to secure this long-term stability, coupled nevertheless with a certain amount of short-term flexibility, such as is required for "corrector" purposes (although the short-term flexible rate should be moved as rarely as possible), the following system might be suggested: namely, for the normal gold points to be widened until there was an *écart* of about 5 per cent., the Central Bank being allowed to vary its buying and selling price for gold within this new limit as it thought fit.

Its policy would be to keep the exchange rate as stable as it could; but it would retain the right to make short-term variations within the statutory, say 5 per cent., limit.

Other countries might then be persuaded to revalue their currencies on what they guessed were about the right parities, in view of all the factors at issue, each retaining the right to vary its own gold-price also within 5 per cent. And all of them agreeing not to move the rate by more than this amount

without a majority vote from, say, the Board of the Bank of International Settlements, or some other selected body.

In other words, just as at the moment of writing the American Administration has obtained from Congress the right to vary the content of the dollar within a 20 per cent. margin, *i.e.* between a 40 and 50 per cent. depreciation, so this *écart* might be narrowed down to perhaps within 5 per cent.

If it were adhered to, such a system might keep the exchange rates fluctuating within fairly narrow limits, about a fixed mean, for long periods on end—which would be of great advantage to long-term international financiers. And yet it would also allow some of the necessary flexibility required from the exchange mechanism as a " corrector." There would also be the additional advantage that day-to-day movements would be eliminated, the Central Banks probably being able to refrain from changing the exchange rates, perhaps for many months on end. Such a system has many merits, for it has nearly all the advantages of paper without the " shocking " effect of complete gold abandonment.

In fact, in view of the state of the world to-day I am inclined to recommend it to start with—although it certainly gives scope for pirate nations to use the comparatively fixed rate of the gold Entente * as a fulcrum with which to secure for themselves the advantage of gold under-valuation.

4. *Temporary Methods of Securing both Stable Exchanges and Stable Prices.*

In opposition to a variable gold standard it has been suggested, particularly by Dr. Einzig in *The Future of Gold*, that if all countries devalue their gold reserves sufficiently, so that

* *N.B.*—It might be thought that Entente nations could agree to levy an *ad valorem* duty of 10 or more per cent. against the goods of any pirate countries. This would certainly have some effect; but since so much international trade is triangular, specific tariff reprisals by the Entente would not be a water-tight system. In order to check, say, Japanese manufactures to Australia, England might have to put on tariffs against Australian apples. Triangular Trade makes punitive tariffs most precarious.

each country becomes the holder of a large surplus reserve over and above what is required as the legal backing to the note issue, each country will for many years afterwards be able to pursue a policy of internal price stabilisation (which will, of course, require deliberate sterilisation of the excess gold holdings); meanwhile it will be able to use its excess gold holdings to settle any debit balances which may mature in international trade and finance.

Under such a system the countries concerned could, for some years at all events, enjoy the dual amenity of stable internal prices and stable gold exchanges.

This I do not for one moment dispute. But the policy is merely a makeshift and not altogether statesmanlike. Sooner or later, one country will lose all its surplus gold reserves and would then have to pursue a policy of either import control, further gold devaluation, or internal price deflation.

Such a policy, in fact, is merely a ruse for *temporarily* staving off the difficulties inherent in a rigid gold standard system.

In the end, every country would successively be faced with the fundamental gold standard problem, and only a temporary respite of a year or two would be obtained from the dilemma of choosing either fluctuating exchanges or fluctuating prices.

The above method might, quite rationally, be used by a good many countries as a stepping-stone to a gradual, and I think inevitable, transition from rigid gold to managed paper with fluctuating exchanges, but it must not be imagined that this temporary ruse provides any permanent solution to the problems (*i.e.* the "corrector" problems) inherent in international trade. Indeed, after some years of its adoption, some countries, seeing that they were receiving payment for their surplus exports in the form of a metal which was useless to them, since they sterilised it, might place an embargo on the import of gold, as Sweden did from 1924 to 1930, thus stultifying the Einzig policy entirely.

At present, of course, it is considered better to receive gold from abroad than goods, but this is only because we live under

a mismanaged economic system, which at the moment makes it better for a country to part with real wealth than to receive it. As we shall explain in Volume III, with a properly managed monetary system this ridiculous paradox will disappear, and countries will then certainly be unwilling to receive for their surplus exports of goods payment in a metal, which they are forced to sterilise, and of which they already hold a useless surplus.

* * *

The above method of temporarily securing stable exchanges and stable prices is certainly less expensive to a government, and to a debtor nation, than instituting a system of exchange stabilisation funds as described in Chapter IX; but countries will not permanently adhere to such a method when once they have learned to control their monetary machinery in such a way that to receive manufactured goods from abroad is no longer deleterious, as at present, but beneficial.

5. *The Possibility of Compromises.*

In an earlier chapter we emphasised that the only three possible "correctors" to the fortuitous inequalities which inevitably arise in the import/export equation and in the international payment balance, were:—

(i) Controlled foreign trade and/or a rationed exchange market;
(ii) Fluctuating exchanges; or
(iii) Fluctuating internal prices.

It is, however, sometimes suggested that instead of countries going the whole hog in any one of these three respects, they might pursue a policy of rational compromise between the three systems.

First, it is suggested that finance ministers should refuse to sanction any large foreign loans which are likely to cause

the exportation of a gold reserve already required, or likely soon to be required, as a backing for the note issue.

Secondly, it is suggested that the foreign exchange market should be rationed and organised so as to prevent the sudden international movements of long-term capital and of short-term funds; with a view to preventing such damage as is nowadays done by so-called bad money migrating from centre to centre under the motives of either fear or gain.

Thirdly, it is suggested that a considerable gold devaluation should be resorted to by all countries at once, so as to put them in possession of large surplus gold holdings, after the Einzig manner, over and above their note-backing requirements at the present level of prices.

Fourthly, if at any time this surplus gold reserve showed signs of being eaten up too rapidly, that the gold-losing countries should then either devalue their gold exchanges month by month by a small percentage until what had obviously been too high an exchange rate was corrected.

Fifthly, it is argued, that although the main objective of all governments should be to keep their internal prices stable,* they might at times be prepared to resort to *mild* open-market operations with the object of altering internal prices *slightly*. (This I do *not* agree with.)

While further (sixthly), if it was not at the moment deemed advisable to resort to such open-market operations, that any deficit in the international equation might be corrected either by import restrictions, or import tariffs—the monetary proceeds of such tariffs possibly being earmarked and used to subsidise the export industries.

* * *

Since we live in a world where sudden change is never popular and where the conservative mind is unwilling to adopt revolutionary schemes no matter how promising they appear

* Perhaps after some modicum of reflation in the case of a country where the price level had recently been deflated far below the relatively rigid and undeflated cost level.

on paper, I am inclined to see in such a process of compromise the future evolution of the foreign exchanges.

Less friction would be caused by such compromises than by either a return to the rigid gold standard, the out-and-out adoption of paper currency with its natural corollary of fluctuating exchanges; or of a strictly rationed foreign exchange market and a rigidly controlled import trade.

It will, however, be necessary for governments, during this evolutionary process, to bear in mind very carefully the *main* economic principles at issue, namely:

I. Not persistently to support an exchange rate which demand and supply, within the market, is showing to be uneconomic; and

II. Not to let the exchanges ever upset the internal stability of money, by dictating supply, regardless of internal demand and the internal price level.

It will be necessary, in fact, for the government to realise that the first axiom of currency policy is that money should be *internally* stable; and that stable foreign exchanges are only of *secondary* importance.*

6. *An Elastic Arrangement of Variable Gold Exchange Rates based on an Index of Internal Prices.*

Before closing this chapter a word or two might be said on a programme, the fundamentals of which occurred to me as a result of reading an article by Mr. Keynes in the *Daily Mail* of June 20th, 1933, wherein he was considering the relationship between the then paper dollar and the then paper pound. My mind was in consequence made to work as follows:

A rigid gold standard has its drawbacks, because internal price levels become upset. A variable gold standard has its drawbacks, because it tends to lead to competitive devaluation,

* Even though movements in exchange rates themselves make international trade more costly, cause more worry to international traders, and perhaps (which I deny !) reduce the volume of international trade and long-term lending.

and thus to make the long-term exchange-value and purchasing power of money depreciate; and paper exchanges have their drawbacks because they fluctuate almost daily. What is wanted, therefore, is a system which has none of these defects. Here a flexible arrangement might be possible.

France, England and America might (just possibly) agree and declare that neither over- nor under-valuation is desirable. They might therefore agree to select some period such as 1931 as their base year, and to assume that any change in internal price indices from that date justified a corresponding alteration in gold parities *; whereas subsequently, in so far as each country succeeded in reflating internally at a *faster* rate than the others, it would be allowed to devalue its rate proportionately: the slowest country being taken as the basis of measurement.

If such a principle were adopted (which I doubt), it would allow the exchanges to keep in step with the relative *success* of each separate country in raising its own domestic prices: the principle would, in fact, be one of a variable gold standard, aimed at not fettering any one country in its policy of reflation. (Such an idea is excellent, provided that *all* nations would play the game fairly.) †

* * *

In case such a system did not, to start with, work well in

* This, of course, is rather assuming, initially, that internal prices are the only determinants of exchange rates. But read on.

† This particular scheme is not Mr. Keynes's, although it was inspired in my mind by reading Mr. Keynes; so please do not hold him responsible. The merit of the scheme is that it to some extent legislates for the transitional period during which prices in different countries are moving at an unpredictable and unequal rate, towards the level at which it is eventually desired to stabilise them. But to move exchange rates *in the wake* of internal prices may be somewhat to put the cart before the horse, especially in a world where anticipatory forces are so strong. Moreover, the scheme which we are about to enunciate is in direct antithesis to Professor Irving Fisher's plan for keeping internal prices stable. He wants to *lower* the price of gold, by say 2 per cent. if internal prices rise 2 per cent. The following scheme suggests that as internal prices are raised, the internal price of gold should also be *raised*. Actually there is no great conflict in these ideas *provided* it is desired to effect a reflation; when, however, the necessary reflation *has been* effected, then it would become necessary to *lower* the price of gold if internal prices rose *instead* of raising it.

practice, owing to the basic rates proving incorrect, it might also be arranged that, in so far as rates were proving themselves out of line *in practice* (by causing certain countries to lose too much gold), the gold-losing countries might be allowed to reduce their rates by say five per cent. for every five or more per cent. of gold that was lost.

Such an arrangement would (as Mr. Keynes pointed out) tend to eliminate *competitive* exchange depreciation, while stimulating healthy competition among the nations in the reflation of their domestic internal price levels until they were again in equilibrium with their relatively undeflated cost levels: not by an unhealthy process of unfair exchange manipulation at the expense of other nations, but by a healthy stimulation of internal business activity.

Such a "variable" policy has much in its favour compared with rigid fixation, which might after a very few months put the brake, in certain countries, on a much-needed internal revival.

7. *Objections to the Scheme.*

But even if the three leading countries did adopt some such elastic gold measure, it would be no guarantee that some other large countries, such as Germany (who has no gold, but would probably like some) or Japan, would not take advantage of the Franco-Anglo-American fulcrum, and peg their own exchanges at heavily undervalued rates, thus capturing not only the gold but also the trade of the latter group.

Indeed, the success of any such system would require the roping in of *all* the large nations.

Some countries, however, would almost certainly refuse to join in this plan; since it would pay them much better to remain outside, and undercut the others.

Most of the countries asked to consider such a system would, in fact, probably come to the conclusion, first that it would prove impossible to choose a fair basic date, and secondly

that a variable gold system was little better than actual fluctuating paper, and thirdly that some countries would not play the game, and that therefore the scheme was not worth attention.

Incidentally, it would be difficult for any important, though goldless, country, like Germany, to join in, unless she had *already* had gold redistributed in her favour.

My final belief, therefore, is that we shall not see any scientific system of this sort, but will probably see different nations compromising between rigid gold standards, import controls, and variable gold standards: some countries concentrating mainly on one feature: some on others; but in practically no cases operating the gold standard according to its authentic rules. In other words, although the gold standard will nominally be retained for some years, in practice it will be operated on the principles of paper, gold being used merely as a buffer stock to level out day-to-day fluctuations.

It is, however, doubtful if gold will *permanently* slide out of monetary use until several large nations have proved *in practice* that the paper method can be efficacious even though the paper itself is not rigidly tied to gold.

CHAPTER XXI

THE PRESENT EXCHANGE AND TARIFF DEADLOCK. 1935

1. Introductory.
2. The exchange deadlock.
3. Reflation is possible despite over-valuation.
4. The tariff deadlock
5. The franc–sterling–dollar triangular.
6. Equilibrium via either exchange or price movements.
7. The slowness of American reflation.
8. France's declared policy.
9. France's objections to devaluation.
10. The desire for safeguards.
11. The national problems of England, America and France.
12. Policies to adopt :—I. France ; II. America ; III. England ; IV. Germany.
13. The future.

1. *Introductory.*

The contents of this rather uninteresting chapter will probably waste the reader's time. The world is in a state of flux and what is written to-day concerning present conditions may soon be stultified by new political actions.

We have already defined the economic principles on which we believe statesmen *should* act. But in a modern democracy, or in an environment of strong vested interests, a politician is not always able to pursue the policy which he believes to be best; he has to take account of the prejudices of his public, and may therefore be forced to pursue a plan of whose defects he is fully conscious.

For instance, a ministry may decide to return to gold at a heavily devaluated rate, not because rigid gold is believed to be the best currency, nor because it is believed that under-valuation does good in the long run, but because it may be regarded as a convenient stepping-stone to the gradual adoption

of more soundly managed money. To stabilise, in order perhaps to unstabilise later, may, in fact, be regarded as a sound method of transition, the restabilisation itself being regarded as provisional, and subject to safeguards in changing circumstances.

Actually, however, the course of events, and not policy, may take charge, and force politicians, if not immediately, at least eventually, to pursue a policy which is sound from the monetary and foreign exchange point of view. Some countries may, of course, overdo their cures and set up harmful reactions in the opposite direction; other countries, by not keeping pace with the cures of their neighbours, may harm themselves because of their principles. The following notes may, however, be of some transient interest to the reader concerned with the present world deadlock in currencies and tariffs.

2. *The Exchange Deadlock.*

The world currency dilemma is briefly as follows:—Whole groups of exchange rates are out of alignment. This condition, coupled with the belief that world prosperity will not return until international trade is restored, leads to an intense desire for government action. But international trade is not supposed to be restorable until the important currencies are stabilised; while stabilisation in its turn is virtually impossible either until gold has been redistributed or until reflation has occurred and trade has revived within the various countries, and thus placed their budgets in a state of equilibrium. This in itself is a currency deadlock. There exists, moreover, the franc–sterling–dollar triangle.

International trade, it is argued, will not revive until the important currencies are stabilised, but that goal will never be reached until the pound is stabilised. The pound, however, is overvalued in relation to the dollar * and undervalued in

* Some authorities deny that this condition any longer exists. See *The Economist* of 2nd March, 1935.

relation to the franc; the pound, therefore, will never be stabilised until either the undervalued franc is adjusted to the overvalued dollar by means of devaluation or internal deflation, or until the undervalued dollar is adjusted to the overvalued franc by means of a rise in the American price level.

There are, however, other factors at issue.

Europe is at present confronted with certain economic problems which, it seems, can be solved only by a general recasting of foreign exchange policy. These problems are as follows:

(i) Bad internal trade and unbalanced budgets, due to the price level having been deflated below the average cost level;
(ii) High tariff walls which impede international trade;
(iii) Exchange rates which are out of true equilibrium; and
(iv) Exchange restrictions and quotas.

To cure the present state of deadlock, two things are necessary: first, to improve internal trade so that tax revenue may increase; and secondly, to lower tariffs and remove exchange restrictions so that foreign trade may expand.

The internal trade of European countries can certainly be made to revive by a policy of controlled currency reflation; but so long as these countries remain tied to gold at the old parities, a policy of reflation is difficult and dangerous, even if all the on-gold countries try to reflate simultaneously. Since the banking systems, the industries, the foreign trade, the tastes, and the commercial psychology of all these on-gold countries are largely different, a proportional inflation of their currencies, even if it led to an equal proportional rise in internal prices (which is unlikely), would have different final effects on their export and import trades; and one country might lose all its gold to the others—unless the exchange market and imports were meanwhile rigidly controlled.

Since then a parallel on-gold reflation is difficult, another

* See Volumes I and III.

method of securing revival in Europe might be for the on-gold countries to abandon gold, at all events temporarily, while they were in process of reflating internally and reviving domestic industry. Then, when the exchanges had apparently become roughly adjusted to the new internal price levels, restabilisation on gold might be attempted.

There is certainly something to be said for this policy, assuming that it is believed that rigid exchange rates are eventually desirable; but statesmen should be warned against believing that, when a paper rate has remained stable for several months "and has apparently settled down," the recent rate is the correct equilibrium for the future. Our rulers should bear in mind that with any given price level, any given exchange rate is almost certainly setting in motion a new series of actions and reactions which after a few months will almost surely, though not quite inevitably, require a new rate to bring about equilibrium.

3. *Reflation is Possible despite Over-Valuation.*

Reverting to the problem of on-gold Europe, it must not be thought that it is quite impossible for a gold-standard country with a heavily overvalued exchange rate to reflate its price level, and enjoy a renewal of trade prosperity, *unless* it first devalues its exchange externally, so as to get into line with the rates of other countries. If an on-gold country is willing to control its import trade and ration its foreign exchange market rigorously enough, it may quite well maintain its exchange rates at an overvalued level for a series of years, *even though* it is raising its internal price level and making its exchange rate more and more overvalued every day. Indeed, by restricting imports, and perhaps subsidising exports, such a country (*e.g.* France to-day) can make quite considerable internal progress, despite the gross over-valuation of its money.

Moreover, if the gold-standard country in question happens to have a huge surplus gold-holding (as France has) it can

export at all events a large part of this gold to pay for its essential imports. Indeed, I calculate that France could, at her present annual rate of export-deficit, remain on the gold standard as at present for at least three years before sufficient gold was lost seriously to endanger a policy of internal credit reflation. But naturally she would have to control her exchange market most stringently to prevent any anticipatory flights of capital.

4. *The Tariff Deadlock.*

As regards the tariff problem in Europe: the ideal, of course, would be for tariff walls to be lowered by agreements, and for exchange restrictions to be removed. But no country appears willing to lower its own tariffs until exchange restrictions have been removed first; and no country appears willing to free its exchanges until tariffs have been removed first. There is, therefore, a dilemma. Moreover, the reduction of revenue-producing tariffs, when once imposed, is hardly practical politics during depressions, since most countries in Europe lack refinement in their tax systems and are consequently forced to rely on tariffs for a substantial proportion of their revenue.

If then it is politically impossible to reduce tariffs, the only other way of preventing high tariff walls from continuing to impede international trade and payments, is to abandon gold and in its stead to adopt paper currencies; for fluctuating paper exchanges largely, though not entirely, nullify tariffs and enable goods to jump over tariff walls. (See Chapter XVII, section 5.)

5. *The Franc–Sterling–Dollar Triangle.*

To-day, however, it is not the declared policy of on-gold European nations to abandon gold and resort to fluctuating paper. The only policy which is (openly) discussed, is devaluation and new gold parities.

The trouble with the world's currencies * is that there are three main groups: the Continental gold *bloc*, the sterling area,

* This section was written in January 1935.

and the dollar; the French franc being some 15 per cent. overvalued in relation to sterling, and sterling being some 15 per cent. overvalued in relation to the dollar. And if Professor Cassel's table on p. 73 is correct, there also exists considerable disequilibrium within the Continental gold *bloc* itself.

Since France is our war debtor, the franc should be somewhat undervalued in relation to the pound, other things equal, so as to secure an export surplus; and the pound in its turn should be undervalued in relation to the dollar, because we are in debt to America, also on war account; while Germany, despite the fact that her over-valuation at the moment is the worst of all (according to Cassel), should have the greatest under-valuation, because she is in debt all round, both on war and peace account.

In fact, the exchange disequilibrium is about as bad as it could be; the countries which should have the highest exchanges have the lowest, and *vice versa*. The result is that America has an export surplus when she ought to have an import surplus; and France and Germany have import surpluses when they ought to have export surpluses.*

6. *Equilibrium via either Exchange or Price Movements.*

There are two main potential cures to this harmful disequilibrium: (i) For the overvalued countries to lower their gold parities, or (ii) for equilibrium to be attained by internal price movements, involving either deflation in France and/or some inflation by England and much inflation by America.

But the difficulty of securing further deflation in France lies in the fact that price deflation is habitually much faster than cost deflation, thus rapidly wiping out the industrial profit margin. This reacts upon internal trade and upon budget revenue, and may eventually involve the government in

* America's export surplus for 1934 was £G.88 m., and she imported £G.200 m. altogether, *i.e.* over double her export surplus.

such a large deficit (probably increased by the need for doles) that France may be forced into an involuntary budget-deficit inflation. Continued deflation is, in fact, an industrial massacre, which cannot be continued for ever. Its logical consequences are bank collapses, machine guns in the streets, followed by inflation to wipe out the stain. In fact, a point is soon reached at which continued deflation is no longer politically possible.

7. *The Slowness of American Reflation.*

What hope then is there of inflation in America reducing the need for French deflation (or devaluation)? *

It is (still) the declared policy of the U.S.A. government to reflate prices (another 25 per cent.) to the 1926 level. But although President Roosevelt has widened the currency basis until there are now enough (new) gold dollars in America to support a price level about five times as high as that now existing, prices do not usually rise rapidly, despite quantitative credit inflation, until a country's industrial plant has become so fully employed that producers are enabled to capture bargaining power from consumers and mark up prices despite their own mutual competition.

At present, however, most plant in America is still some 25 per cent. under-employed, and although the President has laid the monetary foundation for a price inflation, he has so frightened business men about whether or not they will be allowed to retain any profits they may make, that they are too nervous to go ahead and borrow the bank money that is already available. Indeed, until President Roosevelt changes his reputed attitude towards profits, industry and prices will continue to stagnate, at all events until his own borrowing of inflationary money from the banks for public works has so eaten into retail stocks, via the expenditure of the extra men employed on public works, that at last replacement-orders from

* French internal monetary policy is at present largely governed by Mr. Roosevelt.

retailers to producers, and increased industrial incomes and expenditure at retail, set in motion a virtuous circle of increased industrial activity and higher prices.

But unless President Roosevelt changes business psychology rapidly, this may take over a year, and meanwhile France's problems will remain unsolved—unless she devaluates.

What then is the chance of devaluation ?

8. *France's Declared Policy.*

At the moment of writing the French Premier (M. Flandin) states that he will never devaluate, and that he intends to pursue a policy of deflation. (Yet, curiously enough, he is allowing his Finance Minister to institute a policy of cheap money and credit expansion, which is hardly consonant with further deflation !)

But perhaps M. Flandin says one thing and thinks another, for no responsible minister can " talk " about devaluation before he devalues, lest he set in motion a flight of capital and a violent wave of gold hoarding which might upset the banks.

If, however, we are to take M. Flandin at his spoken word, he is relying largely on President Roosevelt and American inflation to get France out of her difficulties—difficulties which are not of her own making because she has been the chief victim of all the *recent* undercutting, both by the sterling group and America. (But she certainly set the pioneer example in 1926 !)

Meanwhile France, judging from M. Flandin's speeches, will deflate. (Or will she reflate, keeping on gold by a process of rigid import control, capital export control, and exchange market restrictions ?)

France can certainly pursue a reflationary policy with greater impunity than any other on-gold nation, because her export (and import) trades are comparatively unimportant to her. And she can play many tricks with ruses like " Tourist francs." Moreover, *if* the surrounding Anglo-Saxon nations remain prosperous, their inhabitants will travel more and drink

more wine, so that France's exports will be largely maintained despite over-valuation. Indeed one might almost say that France's greatest concern with her foreign trade is only in so far as it causes loss of gold and a restrictive internal monetary policy.

9. *France's Objections to Devaluation.*

As regards the French government's objections to devaluation: the first is that no government would stand after a second debasement following on that of the 1920's; the second is pride; the third is the fear that going off gold may be the cause of an inflation; the fourth is that it would raise the cost of living; the fifth is that the policy is dishonest; and the sixth is that England and America might retaliate by even more devaluation. This last question requires some analysis.

10. *The Desire for Safeguards.*

The first thing France would like to know is what the attitude of England and America would be towards any given devaluation. It would be no use for France to devaluate 20 or 30 per cent. if England and America were to retaliate—for it would merely result in the institution of a futile world devaluation race. France would therefore like to receive England's (and America's) assurance that they would abstain from taking any action calculated to upset any new parity selected.

England, however, seeing that the pound is overvalued in relation to the dollar,* and seeing that the dollar may be devalued further, is not in a position to give any guarantees that might restrict her own freedom of action in the future—especially as President Roosevelt still has the legal right to devalue further from the 42 per cent. level to the 50 per cent. level.

The question then arises, Should M. Flandin immediately devalue the franc a full 42 per cent. (or even 50 per cent.) in order to get into line with (or below) the dollar?

* This is still the official view. February 1935.

Such action is not theoretically impossible; but 40 (or 50) per cent. at one fell swoop is probably too much for French politicians to swallow. Moreover, such action would probably set a world devaluation race in motion; for Germany and Switzerland might go one better, and Japan, Holland and Belgium might follow suit.

In addition to the problem of what would be a fair rate for the purpose of removing the *existing* over-valuation of the franc, there exist the following problems:

(i) What war debts are going to be paid in the future, and how much under-valuation-allowance in the new rates ought to be made for them.

(ii) What the *future* internal price policies of the various countries are going to be.

This suggests that War debts must be fixed *before* there is any restabilisation, and that agreements must be made concerning reflationary policies, not only as to their magnitude, but also as to the speed with which they are to be put into effect within each nation. This, however, is an impossible thing on which to give guarantees; so that the prior guarantees which *ought* to be obtained are in practice entirely unobtainable!

Thus, at every turn, there arises a deadlock. The separate problems of stabilisation, War debts, tariffs, and monetary policies, all appear to depend inextricably on each other. Each must be settled before the other, and the others must be settled before each! No wonder France hesitates to devalue, although, to effect revival, she ought to!

* * *

Looking at the English, American and French corners of the triangle separately, the following seem to be their respective points of view:

11. *National Problems.*

A. ENGLAND

Having had one experience of over-valuation in 1925, England does not intend to be caught with another. She is therefore unlikely to return to gold unless she not only regards the rate selected as containing no element of over-valuation *at the time*, but also has sufficient guarantees that no other important nations will undercut her soon afterwards (as they did in 1926), either by means of further devaluation or by means of internal price deflation.

Having led the world in stabilisation in 1925, she is too well aware of the dangers of " taking the lead " to take any action until she has sufficient assurances that sterling will not be used as a fulcrum against which other countries may unfairly manipulate their currencies. England, moreover, is extremely hesitant to return until the question of War debts has been settled, since she knows only too well that outstanding debts are an important factor in determining the extent to which different on-gold currencies should be undervalued in relation to each other.

Meanwhile, England is very happy to enjoy the position of being undervalued in relation to on-gold Europe, even though she is not undervalued in relation to the dollar. She likes, in fact, to enjoy the amenities of freedom of action and partial under-valuation.

Moreover, she is quite anxious for *other* countries to go on adhering to gold, since the British Empire produces 70 per cent. of the output of the world, with an annual market value of £G.70 m. And she realises that any sudden slump in gold (and gold shares) would upset internal confidence.

B. AMERICA

America could certainly relieve a great many of the world's currency difficulties either by raising her internal prices quickly

(adhering to the present gold rate); or lowering her tariffs; or revaluing the gold dollar at a lower, instead of at a higher, gold price. This last policy, however, is entirely unlikely at the moment; nor is she likely to reduce her tariffs. Moreover, she wishes to reserve the right to devalue even further if she wants to, and is therefore unwilling to give any assurance to on-gold Europe. Finally, she wishes to be able to go on enjoying the benefits of an undervalued exchange, combined with a gold influx such as is supposed (i) to give the Americans greater confidence in their currency, (ii) to cheapen money, and thus (iii) to stimulate internal trade.

Some people contend that it is the secret policy of the American government to devaluate to such an extent that on-gold Europe will be forced to devaluate also; the basis of this contention being that American revival will not progress far unless there is world revival; and that there will never be effective world revival until Europe has been forced to reflate, either on gold or off. This argument, however, seems to me rather far-fetched, although it is certainly not unsound theoretically. Personally, I doubt whether President Roosevelt cares much about Europe, or whether he relies very much on foreign trade to stimulate America's revival. But he has certainly taken very strong action to depreciate the dollar in relation to both the Continent and China.

The real trouble in America (March 1935), and therefore the real obstacle to any solutions to the European tangle coming *quickly* from America, is not that the physical and monetary foundations have not been laid for a boom (they have!), but that the right psychological background is missing from the monetary background. Until Mr. Roosevelt succeeds in making American business men believe that he is *anxious* for them to make profits, and big ones at that, no rapid revival is likely. Fear that profits are looked at with disfavour is disastrous to employment and business revival in a capitalist State.

C. FRANCE

France desires trade revival and would perhaps like to reflate, but her politicians (in their ignorance) are so afraid of the responsibility of devaluing or suspending gold payments, that the present ministry is likely to do all it can to avoid devaluation. Several other governments may have to fall before this policy is actually adopted.

France knows moreover that she can probably stay on gold, provided she controls her imports and her capital exports—at all events so long as the surrounding on-gold countries stay on. She is, however, rather perturbed at the weakening allegiance to gold in Belgium and Switzerland, which has followed upon partial devaluation in Czecho-Slovakia and the adoption by Germany of "special" depreciated rates for particular purposes.

France, moreover, does not enjoy being used as a fulcrum by America and England, and there is a rapidly growing party in France which demands *immediate* devaluation, partly in order that the export industries may revive, but mainly so that an internal reflation may immediately be adopted.

But since it is both theoretically and practically possible for France, if she controls her exchange market rigorously, to reflate on gold despite her heavy over-valuation, her policy at the moment appears to be one of mild reflation internally (although M. Flandin calls it deflation!), coupled with the hope "that something will turn up": the chief hope being that President Roosevelt will not devalue the dollar further but that he will soon succeed in raising American internal prices some 25 per cent., England raising hers at about half that rate.

These events cannot, however, be expected to occur within a few months; meanwhile the French trade depression continues and the clamour for devaluation grows daily louder.

At the moment the devaluationists are taking up the attitude that new fixed rates *can* be chosen, and then *permanently* adhered to as in 1926. But, on further reflection, they will

probably agree that a rate must bear some relationship to the future scale of War debt payments, and above all to the internal price policy *subsequently* to be pursued by the various other restabilising nations.

The adoption of rigid and *permanent* rates would therefore seem unwise, or at all events fraught with considerable danger. It is only an undervalued rate that will provide any safety, and that will probably lead to early retaliation by other countries.

France is waiting for something to turn up. It probably will in the shape of a change of government offering to France a " new deal " of Revaluation, Reflation and Recovery.

A war scare, however, with talk of increased demand for materials, budget deficits and inflation, may do the trick first; as might, just possibly, inflation in America.

12. *Policies to adopt.*

I. FRANCE

What France apparently ought to do is as follows (although what she will do is quite another matter):

1. To put price reflation in front of every other policy. This will revive her internal trade and re-balance her budget.

2. Temporarily to prohibit the export of gold (despite her abundant supply).*

The gold export embargo would thereupon cause the franc to fall to somewhere near its correct international level.

3. For six months or a year the exchanges should then be allowed to swing, *i.e.* until the world public had had time to transfer short and long term capital into or out of France as they thought fit.

4. Then, when the franc had found an appropriate new level, France might, if she still wanted to, adopt a Variable Gold Standard: that is to say, remove the gold export embargo, at the same time fixing a new rate for gold internally, *i.e.*

* Devaluation at a fixed new rate is unsound (although it may occur) because the rate can only be a guess, and any fixation will encourage competitive devalorisation elsewhere.

devaluing—but reserving to herself the right to change the new gold parity as the forces of demand and supply appeared to be making it necessary.

It must be emphasised that the wisdom of adopting a variable gold standard would be dependent on interim developments in America, England, etc. The rate itself would, of course, have to depend on interim changes in French and in foreign internal prices; and also on the extent to which other countries were exhibiting a tendency towards unfair undercutting by a process of deliberate exchange depreciation.

5. If, however, French politicians regard it (as they probably will) as "not practical politics" to abandon gold, even temporarily, I think that immediate devaluation (which is *not* the same thing as suspending gold payments), coupled with a statement that "if circumstances demand it the initially selected rate will be altered as occasion requires," would be the best and least disturbing practical policy—even though it is *not* the most scientific.*

II. AMERICA

America's best policy would appear to be as follows:

For the Administration to realise that under the capitalist system the only way to get the unemployed into work is to create the belief among employers that to employ men will be profitable. The Administration should, in fact, abandon many of its recent policies, which, deliberately or accidentally, have made business men believe that the Administration thinks that all profits are rather immoral (even though the Administration occasionally denies that it disapproves of reasonable profits).

Moreover, the Administration should make it clear that its new policy for curing unemployment is a highly capitalistic policy, and exceptionally well suited to the capitalist system, namely, a policy of raising prices without trying to raise costs

* These are suggestions as to what France *should* do. Actually she will probably strive not to devalue.

simultaneously, with the result that a definite profit inflation will occur which will stimulate capitalists to expand their inventories *and* their scale of employment.

Such a process would immediately put hoarded capital into circulation among working consumers *before* any new goods were produced; retail stocks would thereupon diminish and replacement orders would be given to producers. More and more men would rapidly be employed as a result of the prospective profit inflation.

In fact, the Administration should state that although it might at first sight appear unpardonable to try to increase the profits of the relatively rich *before* the poor and unemployed had benefited, nevertheless that in reality this was the only *sensible* policy in a capitalist system, where high employment depends in the main on high profits. The Administration might add, as a sop to anti-capitalists, that it could safely rely on mutual competition among capitalists themselves, to prevent the profits on any commodity remaining abnormally high *for long*; since new investment in any profitable industry *invariably* reduces these profits, with a lag, to reasonable levels, and fosters lower prices, to the *ultimate* benefit of consumers.

The Administration should further declare that if, after a year or two of fairly full employment, commodities began to rise in price beyond the 1926 level, it would contract the currency to prevent any further inflation.

But it should add that it would not *thereafter* make the grievous mistake made by the monetary authorities in America in 1929: namely, that if and when increased capital investment in industry, coupled with anti-inflationary monetary measures, had begun to cause prices in general (as distinct from occasional individual prices) to fall, it would *not* go on with any restrictive or anti-inflationary policy, but would yet again adopt an expansive monetary policy with the object of *maintaining* prices. It would, in fact, re-expand the previously expanded, though recently contracted, volume of money still further, in accordance with any augmented medium-of-exchange demand

or with any increased store-of-value demand due to hoarding. Which is sense.

(The details of such a policy are discussed in full in Volumes I and III of this Series.) The American government should, in fact, make the American public believe that its policy was Reflation, then Stabilisation. This is the *stated* policy at present, but the American public hardly believes it. At present, as fast as Roosevelt inflates the *quantity* of bank deposits, he causes a decline in their *velocity* by scaring the business public. A change of attitude will initiate revival.

III. ENGLAND

1. England's policy should be somewhat similar to that of America. She should appreciate that, under a Capitalist system, in order to get her two million unemployed fully employed there must be a continuous profit expansion until the country is fully at work, or until prices have returned to a level slightly above the relatively rigid and undeflated cost level of 1929.

2. Then England should stabilise her currency internally, in accordance with the principles of Volume I, letting her exchanges swing according to the forces of demand and supply. Although she might, by means of equalisation funds, etc., do a considerable amount to keep short run fluctuations within reasonable limits.

Her main policy, however, should aim at securing stability of prices after a modicum of reflation, the exchanges occupying a position of only minor importance in her considerations.

IV. GERMANY

Germany having only about £7 million of gold, and probably not being able to borrow, must inevitably adopt a paper currency.

Her main policy should, of course, be reflation and then stabilisation of internal prices.

To restore herself to satisfactory health she will have to

try to regain her pre-war export markets. This being impossible with an over-valued exchange rate, she must let her exchanges find a new level and run the risk, which I regard at negligible, of upsetting internal business confidence, as a result of this process.

13. *The Future.*

In future, world exchange-rates seem likely to be subordinated to internal price policies: the exchanges being made to depend on internal prices rather than internal prices on the exchanges. Indeed, the economic Fates have a curious way of ultimately forcing recalcitrant, though would-be orthodox, governments to adopt policies which are for the good of their nationals, even though such policies have been resisted for years in the honest, though fallacious, belief that they involve "an infringement of sound principles."

Gold may still be held as a nominal backing to currency; and in some cases actual reflation may be effected on gold instead of on paper. This I regard as the most likely and the healthiest way out of the tangle, for it implies (some of) the benefits of a well-managed paper system. Gold may remain in nominal use but its clogging influence may be expelled from our economy.

When the countries of the world have at last put both their currencies and their exchanges in order, in accordance with the laws of supply and demand; always increasing or decreasing money when *general* prices and profits begin to fall or rise, and allowing their exchanges to fluctuate as freely as they should, the world will enter upon an era of prosperity and abundance. Nature and science shower wealth upon us; at present, however, abundance is accompanied by want. It is because the world adheres to so-called sound money (which is in reality unsound) that Plenty gives rise to Poverty and Misery.

APPENDICES

APPENDIX A

A METALLIC BACKING TO CURRENCY IS UNNECESSARY

(The Theory of Money.)

1. *Must Money have any Backing?*

One very common argument against the abandonment of the gold standard is that if the metallic backing of a currency were withdrawn, there would be such a decline of confidence in the currency that its value would collapse and trade depression would ensue.

Some even say that the fall in the purchasing power of money would cause a reduction in public buying power and therefore a decline in total consumption.

These contentions need answering; indeed, so much of the argument of this book assumes that the internal money of a country does *not* need any metallic backing at all, that a page or two must be devoted to proving this contention, even though Volume I of this Series contains a full statement of the matter.

2. *The Medium-of-Exchange Demand for Money.*

The value of money, although *slightly* influenced by its gold backing, is determined *in the main* by demand and supply. Demand, however, is a complex conception.

As already stated, money is wanted or demanded by the

public for two reasons: (i) as a Medium of Exchange, (ii) as a Store of Value.

A man's Medium-of-exchange demand for money depends on the size of his income; on the frequency with which he is paid; and on the amount of payments he is likely to have to make before his next anticipated replenishment of monetary income.

Fundamentally, what each man wants is not so much a permanently fixed specific "number" of currency units, but rather whatever number will give him purchasing power over that basketful of commodities in general (*e.g.* bus tickets, lunches, clothes, etc.) that he can afford to, and may want to, buy before his next anticipated replenishment of monetary income. It is, in fact, effective monetary purchasing power over a quantum of miscellaneous *real* wealth that he really requires. This we shall call his "real" demand.

As regards a man's "numerical" demand for money units, so as to satisfy his "real" Medium-of-exchange demand, this will, of course, depend on the price level, on his wealth, and on his own currency habits, *i.e.* on his frequency of income receipts and on the normal punctuality of his bill-payments after receipt of income.

3. *The Store-of-Value Demand for Money.*

Besides his Medium-of-exchange demand for money a person may also have a Store-of-value demand, which will increase if he is nervous and wants to become liquid, or if he anticipates a general fall in the prices of commodities and securities; for he will then consider money as a better "investment" in which to place his surplus funds for the time being.

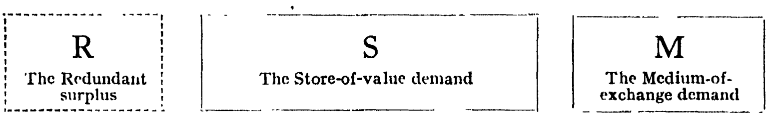
Nervousness, in fact, or the fear or hope of lower prices, may augment a man's aggregate demand for money, *i.e.* the proportion of his total wealth he holds in the form of money, which will tend to make him hang on to any income he receives, rather than spend it; while at the same time he will be inclined to sell his investments and hoard the monetary proceeds. Thus

the net result of an increased Store-of-value demand for money is to diminish the average velocity of money. Moreover, in so far as goods are pressed for sale, velocity of goods may increase while that of money declines, and prices may fall very sharply.

4. *The Influence of Variations in Total Demand.*

How then do the supply and demand for money react upon each other so as to produce, or create changes in, the general price level?

Perhaps the best way of explaining the demand for money in relation to the supply is to portray demand in the form of three rectangles as follows:



The rectangle on the right (M) represents a man's Medium-of-exchange demand for money, as determined by the factors discussed above.

The central rectangle (S) represents his Store-of-value demand for money, which will increase if he is nervous and wants to become as liquid as possible; or if he anticipates a general fall in the prices of commodities and securities and thus regards money as a better "investment" in which to place his funds.

On the left is a dotted rectangle which is meant to represent a man's actual holdings of money over and above his combined Medium-of-exchange and Store-of-value demands. It will, in fact, represent his Redundant surplus of money which he will discard at the first opportunity, *i.e.* pay away in exchange for such commodities, services or securities as he thinks are a *better* investment, from his personal point of view, than holding surplus margins of cash.

Now the growth, or disappearance, of rectangle R (the redundant portion) is a powerful influence on trade, for it will

largely determine the extent to which a man spends money on goods.

The ways in which rectangle R can be increased, in the case of any individual and of the community as a whole, by variations in either demand or supply, are as follows:

(1) By a diminution of the Medium-of-exchange demand.
(2) By a diminution of the Store-of-value demand.
(3) By an inflation of the Supply of money as a whole.

Let us consider these points in order.

Clearly, if a man's currency-using habits change, or if prices fall, he will desire to hold less money for Medium-of-exchange purposes, particularly if his own income has fallen. And this Medium-of-exchange demand may further decline if there are any changes in his personal habits, or increments in the frequency of his income receipts or payments. He may thus (mentally) transfer a portion of rectangle M to rectangle R.

It is possible, however, that while a man's Medium-of-exchange demand is declining, his Store-of-value demand may be increasing owing to him either anticipating a prospective fall in general prices, or wanting to remain particularly liquid through fear. He may, in fact, mentally transfer part of his money from rectangle M into rectangle S.

But when his expectations concerning a further fall in prices eventually come to an end, or if his confidence is restored so that he no longer desires to remain as liquid as formerly, he will mentally transfer part (or all) of the money in rectangle S into rectangle R. In other words, he will decide that he has invested more of his wealth in money than is necessary or desirable; and that he would better himself by spending the redundant portion on pleasure-giving commodities or services, or on income-giving securities.

In this way, a change in mental attitude or confidence may stimulate—via changes in the mental rectangle S—the volume of his personal spending.

5. *The Influence of Variations in Supply.*

But these are only the demand factors in the monetary equation. The supply factors must also be considered.

A person may obviously come into possession of additional money as a result of his own individual exertions or good fortune. But the community *as a whole* can only come into possession of additional money, *at any given moment*, as a result of legal tender or bank credit inflation.

If the volume of money in a country is inflated by say 10 per cent., then, since all the money is held either by some person or by some company or corporation, people as a whole, including companies, will have 10 per cent. more money in their pockets and pass-books; which will mean that if their Medium-of-exchange and Store-of-value demands have remained stationary, they will now on an average be holding a redundant balance of 10 per cent. in rectangle R.

Take, for instance, the day on which the reader is reading this book. Let us suppose that this evening, somehow or other, the bank balances and the cash holdings of every person and corporation in the country were suddenly increased by 10 per cent. (without each person knowing that the balances of other people had been simultaneously augmented). The tendency of each such person or company would be to put the money into something or other, in the near future, which would show a yield either in consumption-enjoyment or investment-earnings, rather than to go on holding the redundant supply in non-interest-giving and non-enjoyment-giving idle money.

The result, not necessarily next day, but sooner or later, would be that individual after individual would begin to spend his surplus funds either on services, securities or commodities.

More commodities would be sold at retail, retail stocks would fall, increased orders would be given to producers, and more incomes would be paid out to workers. Prices *need* not necessarily rise, and indeed will not if, owing to the increased volume of trade being done, and owing to the rise in incomes,

the Medium-of-exchange demand for money increases sufficiently. Indeed, the inflation *may* be followed not by rising prices, but merely by more trade. Increased supply may, in fact, stimulate increased demand.

It is to be noted, however, that if people are fully aware that everyone else has had his cash balance increased by 10 per cent., a general rise in prices will become " anticipated " and that retailers and others will be more inclined to mark up prices than if they had been unaware of the general monetary inflation. Moreover, knowledge on the part of individuals that an inflation is occurring is likely to make them obey the Law of the Rising Market and to expect a rise in prices; this anticipation will automatically reduce the size of their Store-of-value demand for money.

The net result may be that, although their Medium-of-exchange demand has increased, their Store-of-value demand will decrease, perhaps to an *even greater* extent. Thus rectangle R (namely, the amount of redundant money they are holding) is augmented rapidly, not only by the actual inflation itself, but also by the diminution in the Store-of-value demand (rectangle S).

In this way, a 10 per cent. inflation of money as a whole, although leading to increased trade and therefore to an increased Medium-of-exchange demand for money, may nevertheless lead to a rise in general prices of *over* 10 per cent. owing to the Store-of-value demand for money being decreased even faster than the medium of exchange demand has increased.

* * *

Now it is important to note that each individual and each company is subject to these demand-and-supply forces in the monetary sphere. Admittedly an increase in the aggregate supply of money *can* be accompanied by such an increase in the Medium-of-exchange (or in the Store-of-value) demands that prices and trade do *not* rise; but if the increase in total supply continues *progressively*, and particularly if it is *expected* to continue, the increased supply of money will lead sooner or

later not only to an increased demand for goods but also to a rise in prices.

Conversely, deflation (especially if it is expected to continue), although leading to a diminution of the Medium-of-exchange demand, will probably lead also to an increased Store-of-value demand; thus prices will have a tendency to fall *even faster* than money itself is deflated.

6. *How Demand and Supply determine the Price Level.*

If we consider this process from the point of view of the community *as a whole*, what we find is as follows:

People want to have command over a certain quantum of miscellaneous commodities, and the amount of "real" purchasing power they will hold depends on their combined Medium-of-exchange and Store-of-value demands for money.

From time to time, of course, the supply of money and the combined public demands for money may get temporarily out of adjustment, either (*a*) because "real" currency requirements are altering, owing to changes in the volume of business, in currency habits or in sentiment; or (*b*) because total supply has been altered.

Economic forces, however, are always at work which tend to correct these temporary phases of disequilibria, and to give the total volume of money—whatever the name or the number of units composing it—that particular *aggregate* "commodity-value" over which the people of the country see fit to hold effective monetary purchasing power.

If, for instance, disequilibrium exists and people hold more money, in view of the existing price level, than they individually and collectively regard as necessary or convenient for effecting their exchanges, or for that matter as a store of value, they tend to spend their surplus balances.

This spending tends not only to augment the physical volume of trade but also to lower stocks-remaining-on-offer in the shops, and to send up prices; until at last, in view of the

rise in prices, more *units* of money are required "for convenience," *i.e.* so as to give to each individual that full "real" command over the *commodities* in general which his habits and circumstances require.

If, on the other hand, prices rise too far; or, alternatively, if there is a reduction in the quantity of money, and if people in general find themselves inconveniently short of money in their pockets or pass-books, in comparison with the market value of their total real wealth, the tendency is for them to hoard any new receipts of money without spending them so quickly (and to sell goods and securities so as to get in more money), with the result that money circulates more slowly, and the monetary demand for commodities is temporarily checked. Stocks-on-offer then pile up in the shops and prices consequently tend to fall.

Forces are thus always at work to produce that equilibrium in the price level which enables the members of the community to hold, in the form of all the money available, just that real purchasing power which they think fit, not only for store-of-value purposes, but also for effecting such expected and unexpected purchases of goods and services as may seem likely before the next anticipated replenishment of monetary income.

* * *

The above are the ways in which variations in either the Medium-of-exchange or the Store-of-value demand affect the price level. Precisely similar processes operate in the event of a change in the aggregate supply. Redundancy develops, and prices rise, just as if aggregate demand had fallen. But it is, of course, possible for the influence of an increase in aggregate supply to be more than counterbalanced by an increase in the aggregate demand, resulting from an augmentation of either the Medium-of-exchange or Store-of-value demands.

* * *

The above is perhaps rather a heavy statement of the true Theory of Money, but it is just because of its complexity that so many false (though simpler) theories have been seized upon,

appearing not only in economic text-books but also in the speeches of statesmen and bankers.

Indeed so widely accepted have certain false theories become that modern monetary policy is largely based on false theory—and therefore, of course, proves harmful in practice.

7. *A Gold Backing for Currency is Unnecessary.*

Having explained how the value of money is determined by demand and supply, let us now examine (i) whether or not the ratio of gold backing has any effect on this value and (ii) whether notes will remain unchanged in value even if the gold backing is suddenly withdrawn.

If, as we have stated, it is the aggregate "real" purchasing power required which gives the total money in circulation (whatever it is) its value, then it is obviously not a 20 per cent., or a 50 per cent. gold backing which fundamentally determines the price level, but rather the total supply of all forms of money units, in relation to the total "real" demand.

It is true that if the gold backing were reduced, or if convertibility into gold were suddenly withdrawn, people *might* become somewhat afraid and less willing to use money as a "store of value." Their aggregate "real" demand for money might thus decline in consequence of disappearing convertibility; but since they must have some form of money for exchange transactions—barter being virtually impossible—and since notes are legal tender, and since the law will still support the settlement of debts with legal tender paper, people will go on using the inconvertible and unbacked legal tender notes as a "medium of exchange" (and also the bank deposits which are convertible into them), even though they may hesitate to use quite so much of such money as a "store of value."

If gold backing or convertibility is suddenly withdrawn, the value of paper money may thus fall somewhat; but it will not become "entirely worthless" as is often supposed; indeed,

its value will fall (if at all) only in so far as the Store-of-value demand diminishes.

If the people trust their governments and do not expect any *quantitative* inflation of money, experience shows that, even if backing be reduced or convertibility withdrawn, and even though gold-reserve-ratios may decline appreciably, the value of the money, and general prices, need not alter in the least. Indeed, since a loss of gold is often followed by high bank rates and credit deflation, the value of money often *increases* as gold is lost, instead of declining.

From this it can be (rightly) concluded that a metallic basis is unnecessary for currency for *internal* use, since its internal value depends on " real " Demand and Supply—not on what it happens to be made of, nor on its convertibility, nor on its ratio of gold backing.

* * *

What the great mass of modern people require, except those engaged in foreign trade, is that their money shall be convertible into, and have a fixed purchasing power, not over some rather useless metal like gold, but that it shall be convertible into, and have a stable purchasing power over, the things in general which they use and want—*i.e.* goods and services. Gold backing or gold convertibility is of virtually no importance.

Since in many countries bank credit currency is superimposed on gold in a more or less fixed ratio, it must be admitted that the volume of credit currency, and with it the value of gold coins, and prices, tend to be *governed by* fluctuations in the supply of gold. But that does not prove that it is the gold backing which *determines* the value of money *; but rather that gold is, under certain currency systems, the governing influence on the total supply of other forms of money—which supply, in conjunction with real demand, determines its ultimate value.

Indeed, even if the gold backing were entirely eliminated,

* Actually as the gold supply increases, credit tends to be inflated, and the value of money tends to *fall*, rather than rise.

the note and credit currency as such would still have a value and would continue to circulate freely: the value of each unit would be decided, as ever, by supply and demand, *i.e.* (*a*) by the total number of units of deposit-and-note-currency in existence; and (*b*) by the combined Medium-of-exchange and Store-of-value "real" demands.

A gold backing for internal currency is, I repeat, entirely unnecessary. Gold backing may make *some* difference, because of its influence on Store-of-value demands. Its influence, however, is usually unimportant; although if the withdrawal of gold convertibility is expected to be followed immediately by quantitative note inflation, the Store-of-value demand for money will certainly diminish rapidly and prices will rise quickly. But the cause of this rise will be, *not* the withdrawal of convertibility,* but the expected inflation of supply.

Indeed, the only reason for a domestic note issue having any backing at all—either of securities, or metal or commodities—is so that its total supply may be manipulated at will, so that, by selling to the public the assets behind the issue, the Manager of the Currency can effect whatever anti-inflationary measures seem necessary. Gold cannot be sold internally in this manner. Securities (and commodities) can; therefore they are better.

Bank credit currency needs a backing of securities or other assets so that the public may believe in the solvency of the *banks*; otherwise they will encash their so-called deposits for legal tender notes and the banks will collapse. But, from the *domestic* point of view, the *legal tender* note issue of a country needs no backing at all except for the purpose of having assets to sell when anti-inflationary measures become necessary.

Convertibility may be convenient for external trade; for internal trade it is entirely unnecessary.

* Further evidence on this point is, of course, contained in Volume I.

APPENDIX B

AN OUTLINE OF THE CAUSES OF BAD AND GOOD TRADE

1. The circuit flow of money.
2. The motivating forces in trade.
3. The influence of the six great economic groups on trade.

   I. Consumers.
   II. Retailers.
   III. Wholesalers.
   IV. Manufacturers.
   V. Bankers.
   VI. The Government.
   Summary.

1. *The Circuit Flow of Money.*

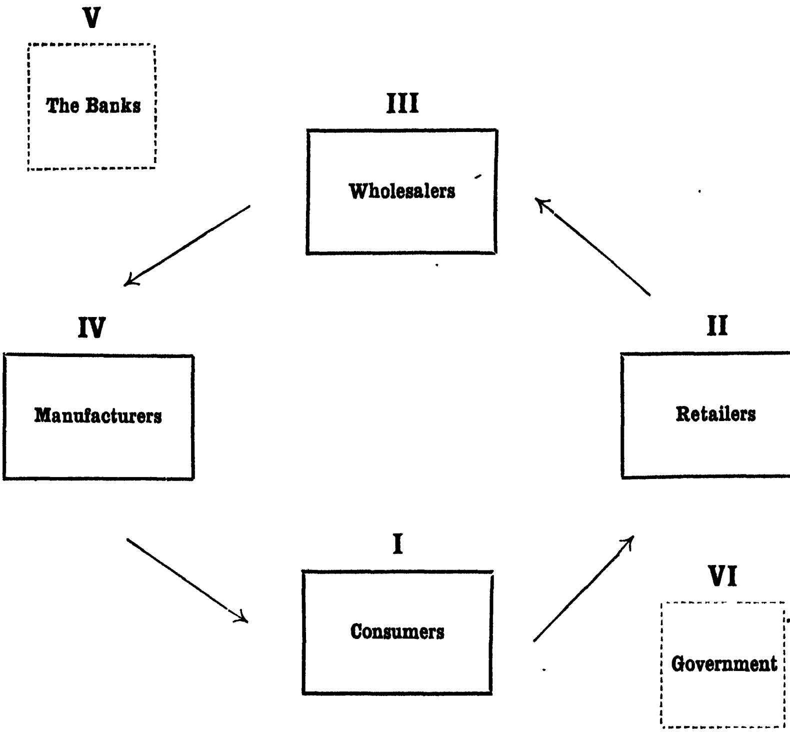
To obtain a clear picture of why trade becomes depressed in the Capitalist System, and of what factors can cause it to recover, it is desirable to visualise the circuit flow of money through industry via the four great groups of trading entities—namely Retailers, Wholesalers, Manufacturers and Consumers.

These four groups, all of whose members are holders of money and buyers and sellers of goods or services, can be represented diagrammatically by four rectangles as in the accompanying diagram.

The normal circuit flow of money is, of course, from South to East, to North, to West, and so round again. A few short circuits can however occur; *e.g.* some money drifts from retailers and wholesalers directly into the consumer rectangle, in the form of wages; while, conversely, some money in the consumer rectangle, instead of being directly spent in the shops, is saved and invested in buying more plant direct from manufacturers. The major part of the monetary flow, however, flows round the complete circuit.

In addition to the above four great groups of " trading " entities there are two subsidiary entities, namely, the Bankers

and the Government, who are also capable of influencing the general circuit flow of money and trade prosperity. These have been represented in our diagram by two dotted squares.



To study the causes of good and bad trade, *i.e.* of a large or small circuit flow of money on to goods, and on to labour, the following is a convenient method, particularly if we aim at instituting cures.

Take each of the six groups separately and consider what particular actions on its part will, by stimulating or checking the circuit flow of money, cause either good or bad trade. We shall thus have a bird's-eye view of the factors influencing trade as a whole; we shall also discover useful clues as to what should be done by each group, or by the government or the banks, so as to stimulate business activity.

2. *The Motivating Forces in Trade.*

But before studying each of these groups in detail the following observations on the two motivating forces in trade, and in the circuit flow of money, are necessary:

I. Whether or not *Consumers* will part with any of the money they hold, depends on whether they think the goods in the shops are worth more to them than the money asked. If they do not think this, *i.e.* if they do not consider the bargains offered them good enough, consumers will hoard their money (*i.e.* continue to hold their wealth in the form of idle money rather than in consumable goods or real capital) and general incomes will come to a standstill. *Attractive bargains* must be offered to consumers or otherwise they will hoard.

II. Whether or not *Producers and Distributors* will part with their money in exchange for services and goods, thus propelling it onwards in its circuit flow, depends on whether or not they anticipate a profit from doing so. If they anticipate no profit they will cease buying goods and labour; and reproduction and general industrial incomes will soon come to a standstill. *Prospective profits* are therefore essential to the continued activity of retailers, wholesalers and producers.

As regards the three profit-seeking groups, *i.e.* retailers, wholesalers and manufacturers, it is important to notice that non-anticipation of profits on the part of *any* of the three groups may bring the circuit flow of money *as a whole* (and of goods) to a standstill; for it will mean that incomes cease at one point in the circuit flow and will not flow onwards afterwards as usual.

* * *

To understand the general problem of good and bad trade, however, it is desirable to examine the six main groups of business entities—namely, retailers, wholesalers, manufacturers, consumers, bankers and the government—in succession, with a view to summarising what series of actions on the part of each will influence the circuit flow of money, either favourably or unfavourably.

Let us turn first to the Consumer group.

3. *The Influence of Group I*, i.e. *the Consumers.*

(i) *Hoarding.*—Consumers derive their incomes from wages, salaries, interest, rents, dividends and doles; and obviously consumers hold a large proportion of the total bank credit currency and legal tender in existence.

If they decide to hoard money, and do not spend it at retail, or invest it, the amount of money *moving* in the circuit flow is reduced. Hoarding is stimulated by either fear, the expectation of lower prices, or the recent satisfaction of existing wants.

Conversely if they reduce their average holdings, *i.e.* dishoard, the circuit flow of money is increased. Dishoarding is stimulated by optimism concerning their own future incomes, by the expectation of higher prices, or by gradual attrition of goods already in use.

(ii) *Bank Borrowing.*—Consumers can, however, influence the total amount of money in the Flow by borrowing from their bankers, either to buy goods at retail or to subscribe to new security issues (with the result that the money will be spent by the borrowers and thereby injected into the circuit stream of money either in the construction of new factories, bridges, houses, etc., or in the production or purchase of more goods or labour).

Consumers may also influence the circuit flow of money by borrowing to speculate on the Stock Exchange, the probability being that sooner or later most of the money thus borrowed will filter into the Industrial Flow either in the form of subscriptions to new issues by the investors who have recently sold securities to the speculators, or in the form of Stock Exchange profits spent on consumable goods (such profits being particularly likely to mature if more money is speculatively spent on securities).

Incidentally, if consumers borrow from their bankers in order to pay taxes, extra money is likely to enter the Flow (unless the government uses the proceeds for paying off its own past bank loans).

(iii) *Instalment Buying.*—Another factor influencing the amount of money in the circuit flow is the buying of goods by the hire purchase system. Such purchases are usually financed by the retailers borrowing the unpaid portion of the amount outstanding from their bankers, and handing on this sum, coupled with the instalment already paid, to wholesalers. Thus the volume of hire purchase may itself be a powerful influence on the quantity of money in the circuit flow.

The Influence of Group II, i.e. *the Retailers.*

(i) *Stock Policy.*—If retailers decide to let their stocks run off, through political uncertainty, or because they expect a lower volume of sales, or because they anticipate a fall in prices, they will give fewer replacement orders to wholesalers, and wholesalers will give fewer orders to manufacturers. Manufacturers will therefore reduce their outputs, and since they will pay out less wages, consumers will not be able to buy so much at retail as before.

Thus a change in the retailers' stock policy can reduce the circuit flow of money. Incidentally, it implies that the money which is not spent by the retailers on goods from wholesalers will be hoarded, or alternatively paid back to the banks.

Conversely, if retailers increase their stocks they will give more orders to wholesalers, and wholesalers will give more orders to manufacturers, so that the circuit flow of money will increase—the increase being financed either by dishoarding of previously hoarded money on the part of retailers, or by additional borrowing on their part from the banks.

(ii) *Wage Scales.*—Another factor capable of slightly affecting the circuit flow of money is the payments by retailers of lower wages and salaries, for less of their own money or of borrowed bank money will be paid out into the circuit flow, and the size of the consumer demand will be thereby diminished.

(iii) *Reduced Bank Loans.*—It should be noted that if the banks call in loans from retailers the latter will be forced to

reduce their inventories, and also to give fewer orders to wholesalers; thus the squeezing of retailers by the banks will itself affect the circuit flow of money.

(iv) *The Hoarding of Profits.*—A minor point is that if retailers, after making profits, fail to pay out any dividends and hoard the money in their banks, the circuit flow of what would otherwise have been dividend-money will be reduced owing to the hoarding of their profits by retailers. (This, of course, also applies to wholesalers and manufacturers.)

The Influence of Group III, i.e. *the Wholesalers.*

The motives which cause wholesalers to reduce or increase the circuit flow of money are virtually the same as in the case of retailers, *i.e.*—

(i) A change in stock policy owing to fear or confidence, or owing to the expectation of lower or higher prices;
(ii) Increased or decreased borrowing from their bankers;
(iii) Lowering or raising wages;
(iv) Hoarding, or full distribution, of profits.

The Influence of Group IV, i.e. *the Manufacturers.*

(i) *Inventory Policy.*—In so far as manufacturers make for stock, without securing orders in advance, a change in inventory policy on their part will alter the volume of their manufacture and will consequently alter the amount they pay out in wages, salaries and other costs. Here, again, fear or confidence, or the expectation of lower or higher prices, will play a powerful part in governing their behaviour.

(ii) *Wage Scales.*—A second factor influencing the total amount that manufacturers pay out into the circuit stream of money is an alteration in their scale of wages and salaries. A reduction in wage rates implies that the manufacturers hoard money, or borrow less from their bankers, and that the

subsequent circuit flow to consumers is, in consequence, reduced.

(iii) *Hoarding profits* has a similar net effect.

(iv) *Bank-borrowing.*—Obviously in so far as manufacturers increase or decrease the amount they borrow from their bankers, either for manufacture itself or for repair of machinery, advertisement, or for paying taxes, the amount of money which they inject into the circuit stream will be influenced.

The Influence of Group V, i.e. *the Bankers.*

The influence of the banks on trade can be either (i) Passive or (ii) Active.

We have already described the *passive* part which banks may play in influencing the total stream of money by granting extra loans, on request, to retailers, wholesalers, manufacturers and consumers; and it follows that if at any time these four groups *voluntarily* repay outstanding loans from bankers, the quantity of money in the circuit flow will be thereby reduced, *unless* the bankers *actively* inject it into public circulation once again by deliberately increasing the quantity of their investments. Indeed it is mainly by changing the volume of their investments that the bankers *actively*, as distinct from *passively*, increase the total volume of money in the circuit flow.

Likewise the banks can *actively* reduce the total amount of money in the circuit flow by calling in loans—either because their cash reserves have fallen, because gold is being lost abroad, because the market value of collateral is shrinking, or because they are nervous about the future standing of their clients or about the future of prices.

It is sometimes said that the banks cannot *actively* influence industry and the price level, and that instead of their actions governing trade, they are merely governed by it. This is not true. They can, and do, at times, play an active, as well as a passive, part in industry.

The Influence of Group VI, i.e. *the Government.*

The government can influence not only the quantity of money in the circuit flow, but also its Velocity.

(i) *The Quantity of Money.*—Assuming a country is not on the gold standard, and that the government controls the note issue, it can inflate the latter and inject extra money into general circulation either by increasing its total expenditure or meeting its budgetary deficits by the injection of inflationary notes into general circulation.

Similarly, by borrowing from the banks a government can influence the total quantity of money in the general circuit stream.

On the other hand, a government can, by increasing taxation or by borrowing money out of the *bona fide* savings of the public, withdraw currency notes, or pay off bank loans, thereby reducing the quantity of money in the stream.

(ii) *The Velocity of Money.*—As regards the speeding up of the Velocity of circulation of existing money, it is to be noted that, if investors in general are too nervous to purchase anything except government securities, a government can, by floating loans for public works, make the *bona fide* savings of the public (which would otherwise have been hoarded) flow more actively through general industry.

Summary.

Reviewing the circuit flow of money as a whole, the following points are worth noting:

(1) General trade, *i.e.* the movement or circuit-Velocity of money, can be stimulated (as well as checked) by action taken at *any* of the four main points of the compass on our diagram: *i.e.* by Retailers on the East; Wholesalers on the North; Manufacturers on the West; and Consumers on the South.

(2) Each of the four trading groups has it in its power to

affect, not only the Velocity of the money in the circuit flow (by either hoarding or dishoarding), but also the total Quantity of money in the circuit flow, either by increasing or decreasing the amount it borrows from its bankers.

(3) It is also to be noted that the bankers themselves, without waiting *passively* either for voluntary repayments of old loans, or for new demands from business for extra loans, can *actively* influence the amount of money in the circuit flow by varying the volume of their own investments in securities and property or by calling in loans.

(4) Furthermore, by inflating paper currency or by borrowing credit currency from the banks in order to balance its budget or to finance public works, etc., the government can also actively influence the total Quantity of money in the general circuit flow. Velocity can also be influenced by the expenditure of loans raised from the public.

(5) Although one or more of the six important groups (*i.e.* consumers, retailers, wholesalers, manufacturers, bankers and the government) may be doing something which tends to diminish the flow as a whole, the other groups may simultaneously be doing something which tends to increase it.

(6) Further, if the six groups are all doing something which augments the general flow, trade will be good; while if all six groups are doing something harmful, trade will be bad.

(7) Finally, since trade in general can be made good or bad either by a change in the Velocity of the money already in the circuit flow, or by a change in its Quantity, the latter factor may be used to counteract the former. Monetary management, in fact, may be used as a weapon to stabilise prices, and to iron out such industrial fluctuation as is due to variations in the demand for money or in Confidence,

APPENDIX C

HOW TO CURE BAD TRADE AND UNEMPLOYMENT

1. Democratic governments are usually afraid of pursuing the policies necessary to capitalism. The voting masses suffer.
2. Profit margins must be protected.
3. The two cardinal principles of government policy.

1. *Democratic Governments are usually afraid of pursuing the Policies necessary to Capitalism. The Voting Masses suffer.*

Much of the depression which occurs in modern industry could be prevented if democratic governments, who express themselves as profoundly concerned with the problem of bad trade and unemployment, would realise that, although they are democratically elected and depend for their votes on a public which, for the most part, are not capitalists except in a very small way, their industrial systems are nevertheless still highly capitalistic.

Although they declare themselves anxious to improve trade and employment, most governments are so busy keeping an eye on the votes of the masses that they either cannot or will not see that what would really improve the condition of the masses most under Capitalism is a highly capitalistic policy calculated in the short run to lose votes.

Any government wishing to stimulate trade and employment in the capitalist system must appreciate that business men will not employ workmen unless they expect profits; and that, therefore, the first essential for curing widespread unemployment is to create the belief among business men, not only that high profits will be made, but also that the business men will be allowed to retain them.

To the unemployed workman it may, of course, appear

that a policy of enriching the capitalist, prior to enriching the unemployed, is immoral and unsound; and many politicians, in their desire to please the electorate, hesitate to advocate any policy which is deliberately aimed at augmenting profits.

But the fact is that we still live under a capitalist system, and so long as this Profits System endures, governments must take the world as it is and *always* pursue a policy promising high profits to capitalist employers. Nor, in the long run, does this apparently unfair policy of favouring the capitalist matter either to consumers or wage-earners.

In the long run, capitalism, by its process of competitive investment, will always tend to reduce profits in any industry to a minimum; for if any one industry becomes abnormally prosperous and makes high profits, new capital, unless monopoly exists, will be attracted into it; and as soon as the gestation period of new plant is over, additional goods will come on the market. This augmentation of supply in a competitive market will soon reduce both profits and prices in that industry, so that the consumer will benefit in the wake of the capitalist.

Similarly as regards wages: other things being equal, employers are anxious to keep wages at a minimum in their *own* businesses. But if an industry, and industry in general, is making high profits, production will expand and more men will be wanted. Competition for men will grow, and trade unions will be able to obtain higher wages for their workers. Capitalists, however, *must* be making high profits *before* the wage-earners have a chance of higher wages. To amplify profits is, under capitalism, the latch-key to high wages and full employment.

2. *Profit Margins must be Protected.*

Therefore if wages and profits at any time are low, and unemployment is rife, the first duty of a government, under the capitalist system, is to create a profit reflation: an enlargement of profits is the *first* goal at which to aim.

Socialists may object, on political principle, to profits as such, and possibly to the social injustice of such a plan; but they must agree, on economic principle, that so long as capitalism endures, this is the most effective policy for governments to adopt, even though they may lose some votes on the part of those who think that all profits should be prevented by government intervention, and that the quickest way to secure socialism is to smash capitalism or let it smash itself.

* * *

The restoration of profit margins may be obtained after a period of deflation (during which most prices have fallen to below the relatively undeflatable cost level, thus showing losses to most business men)—by a process of reflating the price level by monetary means.

This rise in prices may admittedly lower the real value of certain wages, and thus be at the expense of certain workers; but the fact remains that if the current wage level is at present too high for capitalists to make encouraging profits, trade will continue to stagnate, unemployment will increase, and money wages will have to be lowered eventually. The essence of the matter is that employers must see the chance of good profits before production, employment and wages can expand; and if profits have recently been deflated they must clearly be reflated to obtain these objectives.

3. *The two Cardinal Principles of Government Policy.*

The policy of the government should, in fact, be as follows:

(1) That general profit margins should be prevented from falling—and this condition can normally be attained by preventing a fall in the general price level; * and

(2) That if condition (1) above has, for some reason or other, not been observed (*i.e.* if the price level has been allowed to fall), or if the profit margin is declining for some other reason and men are being thrown out of employment, the central

* Volume I explains this in full.

currency authority should aim at immediately reflating the profit level—which can normally be done by reflating the price level through monetary expansion.

A government in a capitalist country should first aim at maintaining a reasonable general profit level. As a general rule (as Volumes I and III will show) this can be obtained by keeping the price level stable.*

* The kind of index to use is discussed in Volume I.

APPENDIX D

THE THEORY OF CONFIDENCE

SUPPORTERS of the gold standard often argue that the abandonment of gold would be followed by loss of confidence in the money of the country, and that the economic results would be disastrous. The orthodox argument is that prosperous business depends very largely on Confidence (correct so far) and that anything which upsets Confidence (a word not usually carefully defined) is bad for business.

But the orthodox party repeatedly reach false economic conclusions because they do not always realise that there are four different sorts of confidence, namely:

(i) Confidence in government finances, *i.e.* in a balanced budget;
(ii) Confidence in the banks, *i.e.* the places where people keep their money;
(iii) Confidence in money itself; and
(iv) Business confidence.

Let us consider these four forms of confidence in sequence.

(i) I hold no brief for unsound government finance, and believe that all unbalanced budgets are dangerous.

(ii) Confidence in the banks is, of course, essential to trade; otherwise the public will encash their deposits for legal tender and cause, first credit restriction and deflation, and then perhaps a run on the banks.

(iii) As regards confidence in money: it looks, at first

sight, as if the more a government could increase the confidence of the public and of foreigners in the national money, the greater would be business confidence, and the better in consequence would be the state of trade. But this, as it happens, is not so.

To increase confidence in money implies creating the general belief that money itself will appreciate in value rather than depreciate; which (i) from the domestic point of view implies the belief that prices will fall rather than rise, *i.e.* that a deflation will occur, and (ii) from the foreign point of view implies the belief that the currency of the country will appreciate over the foreign exchanges.

Neither of these beliefs is good for home trade. Nothing is worse under the Capitalistic system, motivated as it is by Profits, than the prospect of declining prices; while an appreciating exchange-rate stimulates imports and checks exports, thus reducing profit margins and upsetting Business confidence.

The ideal, of course, is a suitable confidence in money, but not *increasing* confidence. The practical question is one of moderation and degree—for obviously *complete* lack of confidence in money should be carefully guarded against.

(iv) As regards Business Confidence: Business Confidence emanates from the belief among business men that they will be able to make profits; and such a belief is largely fostered by the anticipation of a rising, rather than a falling, price level. In other words, Business Confidence can to some extent be engendered by *slightly* destroying Monetary Confidence. It may sound criminal to make this remark; it is, however, entirely true.

As regards the inter-relationship between business confidence and monetary confidence: I am far from saying that all prospective rises in prices are healthy. If, however, the general price level has recently been deflated below a relatively undeflated cost level, definite reflation on the part of the government is the only wise and sensible policy—even though, in

terms of words, such a policy can rightly be stigmatised (sic) "as destroying Confidence in Money."

If, on the other hand, the price level has *already* been reflated into line with the cost level, I am *not* in favour of further inflation—*i.e.* reducing Confidence in Money still further; for if such a policy were pursued it would set up new disequilibrium in the opposite direction. The fact remains, however, that at certain stages of the business cycle it *should* be the policy of the government to reflate prices—*i.e.* to destroy, rather than to increase, monetary confidence! [But such a policy, of course, should not continue *for ever*; for just as a man can either eat healthily or over-eat, so can a government reflate healthily or over-inflate. Inflation should cease when the price level is again in line with the relatively rigid cost level.]

The government should, however, realise that, in so far as its spokesmen declare that they are anxious to restore business confidence by raising prices, it is merely the same thing as saying that they are anxious, for the time being, to reduce (destroy, if you like!) Confidence in Money. To talk otherwise is sheer nonsense.* And it is particularly nonsensical to say, in a country which is anxious to raise its internal price level, as in Central Europe to-day, that the withdrawal of gold convertibility will, by destroying Confidence in Money, upset business confidence and engender bad trade. So far from this being the case, trade will actually benefit from such a policy.

The essence of the matter is that Business and Monetary confidence are largely in conflict. Confidence in money is created by Deflation, which destroys business confidence. Business confidence, on the other hand, is created by (mild) inflation and reflation.

* Unless it is regarded as sensible to raise prices by creating general scarcity.

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The Coming Collapse in Rubber

Published in the rubber boom of 1925–6 when rubber stood at twenty-five times, and rubber shares at five times, the levels subsequently reached.

The Coming Rise in Gold Shares

A pamphlet published in February 1931. Gold shares subsequently rose 150 per cent.

Inflate or Perish

A plea for the reflationary monetary policy since adopted in both England and America.

The Course of the Coming (English) Boom

This pamphlet, published two days after the departure of England from the Gold Standard, analysed the industries which would benefit and suffer from the devaluation of sterling. Since publication the averages for English shares have risen 60 per cent.

The Coming Rise in Wall Street

Published April, 1933. The Dow Jones Index of American Industrials rose 90 per cent. within four months.

Reparations, Trade and Foreign Exchange

Germany and Her Debts

These two books published in the early 1920's forecast the subsequent currency collapse in Europe.

Copies still available

The Coming Collapse in Gold

Publishers : St. Clements Press, Kingsway, W.C. 2. Price 5s.

This book was published in November 1933, two months before America returned to gold. At that time the London price of gold was determined by the over-valued sterling franc exchange, with the result that if the franc declined 15 per cent. to its proper level, the price of gold in London would collapse 20s., which fall would make all sterling-area gold shares at their then prices heavily over valued. It was emphasised, however, in Chapters XIII and XXX that if any important country returned to gold at an *undervalued* exchange rate (as America has done) there would be a further (temporary) upswing in sterling-area gold shares.

The Coming American Boom

Publishers : St. Clements Press. 28th Thousand. Price 5s.

This book discusses the manner in which Mr. Roosevelt's monetary policy will set a boom in motion. Since this book was written in July 1934, the Dow Jones Index for Industrials has risen from 86 to 107, *i.e.* 24 per cent.

Gold : Boom or Slump

Publishers : St. Clements Press. Price 5s.

A critical examination of the outlook for sterling and gold shares. March 1935.

	Population (000,000).	Gold Holdings (in millions of $).*	Area (000 sq. kms.).†
I. EUROPE:			
Germany	65	32	469
Austria	6·8	45	84
Belgium	8	590	30
Bulgaria	5·5	19	103
Denmark	3·6	60	43
Spain (incl. Canaries)	24	740	503
Estonia	1·1		48
Finland	3·5		388
France	42	5,443	551
Greece	6·2	40	130
Hungary	8·7	23	93
Italy	41	520	310
Latvia	1·9		66
Lithuania	2		56
Norway	2·8	61	323
Netherlands	7·9	582	34
Poland	32	95	388
Portugal	6·4	67	89
Roumania	18	103	295
United Kingdom	46	1,583	244
England and Wales	40		151
Scotland	4·8		79
Northern Ireland	1·3		14
Irish Free State	3		69
Sweden	6·1	160	449
Switzerland	4	624	41
Czechoslovakia	15	112	140
Yugoslavia	14	54	249
Turkey in Europe	1	22	24
Turkey in Asia	13·8		739
U.S.S.R. in Europe	116	716	5,999
U.S.S.R. in Asia	25		14,993
,, in Transcaucasia	5·8		185
Total for Europe	**515**		**11,420**
Total (excl. U.S.S.R.)	**384**		**5,420**
Europe plus the entire U.S.S.R.	**549**		**26,596**
II. AFRICA:			
Egypt	15	55	1,000
Ethiopia	5·5		900
Union of South Africa	8·3	173	1,222
Belgian Congo	10		2,385
Nigeria	19		877
Kenya	3		583
Uganda	3·6		244
Sudan	5·6		2,611
French Africa	36		10,400
Italian Africa	2·3		2,250
Portuguese Africa	7·3		2,070
Mandated Territories (incl. Tanganyika)	13		2,460
Total for Africa	**144**		**29,956**

* November 1934. Revalued dollars on the basis of $35 = 1 fine ounce of gold.
† Sq. km. = 0·3861 square mile. Sq. m. = 2·5899 sq. km.

	Population (000,000).	Gold Holdings (in millions of $).*	Area (000 sq. kms.).
III. AMERICA:			
NORTH AMERICA:			
Canada	10·7	133	9,542
United States	123	8,132	7,839
Total for North America	**136**		**19,635**
MEXICO AND CARIBBEAN:			
Mexico	17	25	1,969
Cuba	4		114
Guatemala	2·2		110
Haiti	2·6		26
Total for Mexico and Caribbean	**36**		**2,764**
SOUTH AMERICA:			
Argentine	11·8	403	2,793
Bolivia	3		1,333
Brazil	44		8,525
Chile	4·4	29	742
Colombia	8·8	22	1,150
Ecuador	2		307
Paraguay	0·9		458
Peru	6·6	19	1,249
Uruguay	2	82	187
Venezuela	3·3		912
Total for South America	**87**		**18,143**
Total for America	**259**		**40,541**
IV. ASIA:			
China	450		11,103
India	359	275	4,675
Japan	66	392	382
Persia	9		1,626
Turkey in Asia	13·8	22	739
,, in Europe	1		24
U.S.S.R. in Asia and Transcaucasia	30·8	716	15,178
,, in Europe	116		5,999
Ceylon	5·4		66
Malaya	4·2		136
Philippines	12		296
French Indo-China	22		737
Korea (Chosen)	22		221
Formosa (Taiwan)	4·9		36
Netherland Indies	62	(Java) 77	1,900
Total for Asia	**1,113**		**41,900**
Asia excluding China	**663**		**30,800**
V. OCEANIA:			
Australia	6·6	nil	7,704
New Zealand	1·5	25	268
Total for Oceania	**10**		**8,550**
WORLD TOTAL	**2,041**	**21,636**	**132,360**
WORLD TOTAL (excluding China)	**1,592**		**121,260**

All figures from the League of Nations Bulletin.